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FIRST ANNUAL HEARING ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE TREASURY REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

MAY 5, 1989

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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FRIDAY, MAY 5, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:15 a.m. in room SD–538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Sarbanes, Dixon, Kerry, Garn, Heinz, Bond, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

I want to begin by saying that this is our first hearing on the international economic and exchange rate policy reports prepared by the Treasury Department pursuant to provisions in the 1988 omnibus trade bill which this committee insisted be part of that law.

I want to especially thank the Secretary for being with us this morning at this early hour. I know he has other activities at the White House a little later in the morning. His presence indicates to the committee clearly his deep interest in this subject and concern about it with respect to the reports and the importance of the issues that the reports deal with.

It's clear that exchange rates are vital to our trade and competitive position in the world economy. Some countries have been identified as manipulating their exchange rates to obtain an unfair trade advantage. Obviously, that hurts America. It hurts American workers and companies and, in turn, our national income.

In 1970, only 12 percent of America's total GNP was involved with exports and imports. That figure is now double, to 24 percent, and continues to rise all the time. So we are in the global economy to stay and it's essential that the exchange rate issue be understood and handled in such a way as to afford fairness to this country and to help maintain an open and equitable world trading system.

I want to just say one other thing and that is Senator Sarbanes and Senator Heinz have both given particular leadership in this area of the committee's work and that was essential to the aspect of the trade bill as it was enacted and I very much appreciate their leadership especially in that area.

I also want to say that we have with Secretary Brady today, Under Secretary Mulford. We expect to see a good bit of both of

you but also, Mr. Mulford, we expect to have an opportunity to see you with greater frequency here because of the nature of how the changing patterns of the world economy bring the activities you're responsible for directly before this committee.

So with that, let me yield to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Mr. Secretary, it's very nice to have you here on a different subject than S&L's. In the 15 years I have been on the committee I don't ever remember only discussing one subject from January until May, and it wasn't that we didn't love you but we just got a little bit tired of all of those weeks of discussion. We are happy the Senate is through with it and certainly appreciate all of the work and effort and the help you put into this committee and your staff so that we were able to finish that bill.

So it is nice to have you here on a different subject, on the first annual hearing on international economic and exchange rate policy. These issues are critical to the financial health of the U.S. economy, yet unlike U.S. monetary policy which has long been the subject of regular hearings with the Chairman of the Federal Reserve Board, the committee has not devoted the same level of attention to international financial issues.

Since the passage of the 1987 trade bill, however, the committee has been receiving regular reporting on these issues from the Treasury. Today we open a policy dialog with you, the Secretary.

Fortunately, we are able to begin our discussion with considerable good news on the performance of the industrial economies in 1988 and the prospects for the future. At the same time, we continue to face a daunting task in balancing our external accounts. I believe U.S. policy will benefit from expanded public discussion on these vital issues like the value of the dollar and the trade and financial practices of our major trading partners.

I look forward to your testimony today and, again emphasizing an area that I do not believe the committee has spent enough time on.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman.

I want to express my appreciation to you for calling this hearing so promptly after the submission of the report by the Treasury.

This is a very important development in the efforts of the Congress to conduct effective oversight over the conduct of international economic and exchange rate policy.

I think one of the important contributions this committee made last year to the omnibus trade bill was title III on international financial policy, exchange rates and international economic policy coordination.

The Treasury submitted its first report under that requirement pursuant to the trade bill last October but the Congress was not in

session and, of course, we were not able to hold a hearing at that time in order to review the report.

The latest report constitutes a written update of developments and I'm very pleased that we are now holding this hearing, that the Secretary will be able to be with us, albeit for a short period of time, and that Under Secretary Mulford is here as well.

I think that this is a very important aspect of the working together of the executive and the Congress to develop a coherent policy towards the exchange rate issue. I want to commend the Treasury for the obvious seriousness with which they have taken this issue. It's reflected in the quality of the reports that were submitted, both in October and the one which has just come up.

The trade bill requires the President and the Treasury to confer and negotiate with other countries to achieve better coordination of macroeconomic policies and more sustainable levels of trade and current account balances and exchange rates consistent with such balances. It also requires the Treasury Secretary to analyze and consider whether countries manipulate the rate of exchange between their currency and the dollar for purposes of gaining unfair competitive advantage in international trade. And if the Secretary considers that such manipulation is occurring, the bill requires him to initiate negotiations with such foreign countries to ensure they adjust the exchange rate of their currencies.

The Treasury has in fact been doing that subsequent to the first report last October and with some success, although I am here this morning to say that I think they need to continue to press forward on this issue.

The designation of Taiwan and South Korea for currency manipulation and the negotiations which subsequently ensued are an important indication I believe of the provisions of the trade bill. I want to be very clear about this. I must say I think that in our relationship with other countries there needs to be a perception abroad—and we may look at other countries besides Taiwan and South Korea—but an open, expanding world trade environment, which I am very much in favor of, requires that the rules apply both ways and that there be reciprocity. It does not encompass the concept that a nation should be able to manipulate its currency in that context in order to gain a trade advantage, which I feel very strongly is something we have confronted and which the Treasury has been trying to address.

Second, I think as the trade bill reflects it requires that the rules of trade apply both ways in terms of access to markets, restraints, restrictions, impediments and so forth, so that one nation isn't able to gain, for instance, relatively free access into our market and not provide a response.

And third, I must say that I think there has to be some addressing of the burden-sharing concept. The United States carries a very heavy defense burden that provides a security umbrella for a number of other countries. Beneath that umbrella, there's an intense economic competition. That's fine if that competition is on a fair basis, but at the same time it seems to me we need to have some better sharing of the overall burden. Otherwise, we are carrying the burden for others' benefits and yet at the same time we face this economic situation.

So I think these questions of reciprocity, no currency manipulation, reciprocal trade rules, and some notion of burden-sharing is very important and I am anxious to hear this morning this report from the Treasury on their efforts over the last few months specifically to address this currency manipulation issue.

The CHAIRMAN. Very good, Senator Sarbanes.

Senator Pressler.

OPENING STATEMENT OF SENATOR PRESSLER

Senator PRESSLER. Thank you very much, Mr. Chairman.

I wish to join my colleagues in welcoming Secretary Brady before this committee and take this opportunity to compliment him for his invaluable contribution in fashioning and leading the way in the Financial Institutions Reform Recovery and Enforcement Act, as was acted upon by this body.

Also, I might say that coming from an agricultural State, we are particularly interested in the international economic and exchange rate policy because probably none of our exports are more affected than agricultural products, which constitute the largest portion of U.S. exports. I am particularly concerned with South Korea and Taiwan and their exchange rate policies. We want a level playing field.

The agricultural groups and farm groups have not been active enough, in my judgment, in exchange rate policy as it affects our exports.

So I thank the Department of the Treasury for its report to the Congress on international economic and exchange rate policy.

I also have with me today a report on how our agricultural exports are affected from countries such as South Korea and Taiwan with a slight adjustment on their exchange rate policies.

So we are very interested in this in the agricultural community and I look forward to the testimony of Secretary Brady and Under Secretary Designate Mulford.

The CHAIRMAN. Mr. Secretary, before you begin, let me also express the appreciation of this committee for the quality of the working relationship that we have had on the savings and loan issue. It's a tough one. You stepped up to it right off the bat and we have been able to work together directly and openly. That's the way Government ought to work and I'm just very appreciative of the relationship that we have been able to establish back and forth, and I know the committee feels exactly the same way.

STATEMENT OF NICHOLAS F. BRADY, SECRETARY OF THE TREASURY, ACCOMPANIED BY DAVID MULFORD, UNDER SECRETARY-DESIGNATE OF THE TREASURY

Secretary BRADY. Thank you, Mr. Chairman, and I assure you that we at the Treasury share those feelings about the working relationship that existed during the movement of the S&L bill to the floor of the Senate. We've got some more rivers to cross, but I can assure everybody within hearing distance that we wouldn't be where we are without your leadership and the help from ranking member Senator Garn, and other members of the committee and

we are grateful for it and I think the work product shows the results of that cooperation.

I would also like to thank you this morning for holding the hearing a few minutes early and allowing me to make a meeting at the White House at more or less the same time. I have with me, as you mentioned, Under Secretary of the Treasury Designate David Mulford, in whose department the work on this matter has been done. So I think you are in very good hands.

I welcome this opportunity to review the administration's international economic and exchange rate policy and to discuss the issues raised in the latest Treasury Department report on this subject.

In particular, I would like to focus today on two aspects of U.S. international economic policy. First, our efforts to coordinate economic policies with other major industrial countries to achieve a growing world economy with low inflation, reduced trade imbalances, and greater exchange market stability. And, second, our bilateral negotiations with Korea and Taiwan to achieve economic and exchange rate policies in these newly industrializing economies that are compatible with their growing role in the global economy and their increased responsibility for maintaining an open world trading system.

ECONOMIC POLICY COORDINATION

The economic policy coordination process is now an accepted feature of the international economy landscape. The Group of Seven—so-called G-7—United States, Japan, Germany, United Kingdom, France, Canada, and Italy—meet regularly to review economic policies and performance. Measures to achieve shared objectives have been agreed upon and implemented. Close and continuous cooperation in exchange markets has contributed to more orderly currency arrangements.

Last year represented a notable success for the coordination process. Economic growth in the G-7 exceeded expectations and provided a strong impetus to world trade. Moreover, that growth was better balanced and supportive of a reduction in global trade imbalances, particularly a $34 billion decline in the U.S. trade deficit. While inflation picked up a bit in some countries, it remained modest and there was no evidence that generalized inflationary pressures were emerging. Finally, exchange markets were generally stable.

The strong performance in 1988 provides a sound basis for continued progress this year. Prospects are for solid growth in the major industrial countries in 1989, in the 3 to 3½ percent range. The more moderate pace of private consumption and investment and the new productive capacity resulting from last year's investment will help to keep inflation pressures in check. Moreover, the basic pattern of growth has improved in the last 2 years. Domestic demand exceeds output in major surplus countries, whereas in the United States domestic demand is running below total output. This should contribute to a further reduction of global trade imbalances, although at a slower pace than during 1988.

The G–7 recognize that continued economic growth—which remains the central objective of economic policy coordination—requires that inflation be resisted where it is emerging and that external imbalances be reduced further. In countries with large fiscal and external deficits, especially the United States, further reductions in budget deficits are crucial. A reduction in the U.S. budget deficit through curbs on Government spending would free resources for exports and investment. It would also help improve domestic savings and reduce the need for foreign savings. And, as importantly, it would demonstrate U.S. determination to tackle its own economic problems. Our efforts to get other countries to make the hard domestic choices that are necessary will succeed only if the United States demonstrates leadership and does its part by reducing the federal budget deficit.

The recent bipartisan budget agreement is an important step forward. But our trading partners are skeptical. They want to see the proof, in terms of further reductions in the deficit. We—the administration and Congress—must act promptly to implement fully the budget agreement and meet the Gramm-Rudman deficit reduction target for fiscal 1990. We also need to go further so that the deficit reduction targets for fiscal 1991 and beyond are met.

The reduction of trade imbalances requires effective action by both deficit and surplus countries. The surplus countries must also do their part by improving domestic demand growth, restructuring their economies to reduce dependence on exports, and removing barriers which prevent full foreign access to their markets.

Japan has undertaken a major effort to increase demand and is experiencing the fastest growth among the major industrial countries. Despite this growth and the effects of a significant past appreciation of its currency, Japan's trade surplus declined only modestly last year and is expected to be little changed in 1989. Clearly, further progress is needed to implement effective structural reforms that will open the economy to foreign goods and services and direct domestic production to the home market.

In Germany, progress has been less satisfactory. Despite some improvement in overall growth last year, the current account surplus rose to record levels and is expected to rise further this year as growth in domestic demand slows. More needs to be accomplished to encourage domestic growth and to remove impediments to investment and job creation.

ASIAN NEWLY INDUSTRIALIZING ECONOMIES

Responsibility for preserving a strong, stable world economy extends beyond the G–7. The newly industrial economies of Asia have benefitted greatly from an open, growing international trading system. They must also do their part to reduce global imbalances by allowing the value of their currencies to reflect the strength of their economies and bringing down barriers to trade and investment.

In the October 1988 report, the Treasury Department concluded that Korea and Taiwan were "manipulating" their exchange rates to gain a competitive advantage within the meaning of the 1988

trade act. As required by the act, negotiations with Korea and Taiwan have been initiated on their exchange rate policies.

These negotiations have resulted in some welcome progress. The currencies of both Korea and Taiwan have appreciated further, recent evidence suggests that a structural decline in their external surpluses may have begun and they are taking steps to open their markets and internationalize their financial systems. Nonetheless, we believe there is a need for more progress.

Last year, Korea's currency, the won, appreciated by nearly 16 percent, including about 4 percent in the 6 weeks following the release of the Treasury report in October. However, the adequacy of the won's appreciation in 1988 must be judged in light of much slower appreciation of the won in 1987 and the fact that in 1988 Korea's global current account surplus grew by 44 percent to $14.3 billion or 9.1 percent of GNP. Bilaterally, the U.S. trade deficit with Korea remained unsustainably large in 1988, at $9.5 billion, even though the deterioration slowed considerably due to stronger growth of our exports to Korea and decline in the rate of growth of our imports.

Preliminary data for the first quarter indicate a significant decline in Korea's trade and current account surpluses, including the imbalance with the United States. Unfortunately, the Korean authorities' response to these welcome developments has been to reduce sharply the pace of the won's appreciation this year. Since the beginning of the year the won has strengthened by only 2.7 percent against the dollar. Much of this occurred since late March, following another round of negotiations and the beginning of the preparation of our April report. We believe that the Korean current account data are too limited and preliminary to confirm that a trend toward a structural, lasting decline in Korea's external surpluses is underway. Thus, further appreciation is necessary to sustain and reinforce these recent welcome trade developments.

Toward this end, our negotiations with Korea in the coming months will be aimed at obtaining assurances of continued appropriate appreciation. Moreover, we will seek to engage the Korean authorities in a broad dialog on their capital markets, including exchange controls and the banking and securities markets. Such discussions would be aimed at improving the efficiency and openness of these markets. In addition, we will seek to obtain an understanding that comprehensive capital and exchange controls used to manipulate the exchange rate would be dismantled over the medium term and that market forces instead would be allowed to determine the rate.

A reduction in Taiwan's external surplus also seems to be occurring. Last year, Taiwan's global current account surplus fell by 43 percent to $10.2 billion. Taiwan's trade surplus with the United States, which accounts for 95 percent of its global trade surplus, fell 26 percent to $12.7 billion, although more than half of this reduction reflected purchases of U.S. gold which have been discontinued. Preliminary data for the first quarter of 1989, however, point to further reductions in Taiwan's trade surplus with the United States.

In large measure these declines have resulted from the NT dollar's past appreciation. Moreover, since the October report, the cur-

rency has appreciated further, by roughly 12 percent, including about 5 percent since the release of the April report. We believe this will reinforce the positive trends in Taiwan's external surpluses.

Given the appreciation since the October report—particularly following last week's release of our latest report—and in light of recent trade data, there may be no need for further appreciation at this time. We will, however, continue to monitor Taiwan's trade and exchange rate developments closely to ensure that momentum toward external adjustment is sustained.

We will also monitor carefully implementation of Taiwan's new exchange rate system, without which the recent appreciation would not have occurred. This system, which the Taiwanese authorities proposed during our negotiations, has the potential for achieving a market-based exchange rate. However, implementation of the system is at an early stage and a number of operational problems remain which could severely limit the effectiveness of the liberalization.

CONCLUSION

In conclusion, Mr. Chairman, substantial progress has been achieved in recent years in promoting sustained noninflationary growth, reducing external imbalances and fostering greater stability of exchange rates. The major countries have a special responsibility to play in continuing this progress. Others, however, have a clear and complementary role to play. Our bilateral negotiations with Korea and Taiwan have achieved important progress that could set the stage for lasting significant reduction in their external imbalances. In the period ahead, we will aim at ensuring that these economies play their appropriate role in promoting effective balance of payments adjustment and avoiding a competitive advantage in international trade.

Mr. Chairman, if I may make just one additional statement before having to go to a meeting at the White House, I would like to say that the meetings that we do have with countries such as Korea and Taiwan with something specific to focus on—and I refer to the issuance of these reports—is an enormously useful vehicle for focusing the attention of countries such as Korea and Taiwan on the problem and on our concerns about the trade imbalances that we face.

This method of bringing together the people that are involved in this problem is extremely useful because it does focus people's attention on the fact that a report has to be issued and I must say the figures that were included in the report show substantial progress around the timing of those reports. At the same time, I don't want to indicate that the finance ministries of these countries and trade ministries are unmindful of their broader responsibility—they are. But, like any checkpoint, it's enormously useful to have this kind of a dialog over something specific so the conversation doesn't wander into global concerns of one kind or another and stays tacked down to the realities that I know all of you on this committee think are important.

So I just did want to add that addendum to what I have said and congratulate whoever it is that put that process at work. It seems to me it's really working.

[The complete prepared statement of Secretary Brady follows:]

DEPARTMENT OF THE TREASURY

Report to the Congress
on
International Economic and Exchange Rate Policy

April 1989

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PART I: INTRODUCTION

Section 3005 of the Omnibus Trade and Competitiveness Act of 1988 (Pub. L. 100-418) requires the Secretary of the Treasury to submit to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives a report each October 15 on international economic policy, including exchange rate policy.

The initial report was submitted in October 1988 and provided an analysis of exchange market developments, including the underlying economic factors and the impact on the U.S. economy; an assessment of which countries were "manipulating" exchange rates within the meaning of the legislation; and recommendations for changes in U.S. economic policy to attain a more appropriate and sustainable current account balance.

Section 3005 also requires the Secretary to provide a written update of developments 6 months after the initial report. This report provides such an update. Part II reviews recent developments in the world economy, including developments in the U.S. balance of payments and efforts by the major industrial countries to coordinate economic policies. Part III analyzes the situation in the foreign currency markets, including the impact of changes in the exchange rate for the dollar on the U.S. economy. Part IV provides a status report on negotiations with Korea and Taiwan, economies which were considered in the October report to be "manipulating" their exchange rates, within the meaning of the trade legislation. The final part provides conclusions on the principal issues discussed in the report.

PART II: WORLD ECONOMIC PERFORMANCE AND OUTLOOK

Global Economic Developments

o Overview

The economic expansion in the industrial countries that has been underway for six consecutive years strengthened substantially in 1988, contributing to a very strong increase in world trade growth and helping the Less Developed Countries (LDCs) record their highest growth rate of the decade. In addition, the pattern of growth both within and among the seven largest industrial economies last year provided essential support for global current account adjustment. The U.S. current account deficit was reduced considerably in 1988 while the surpluses of Japan, the European Community and the four Asian Newly Industrialized Economies (NIEs) also declined. Consumer price inflation in the industrial countries picked up slightly again in 1988, albeit to a rate that was only slightly above the 20-year low reached in 1986. (See Table 1.)

The basically favorable macroeconomic trends that were evident in 1988 have generally persisted thus far this year, promoting confidence that industrial country growth will continue, albeit at a more moderate pace, at least into 1990. Partly as a result, the LDC economies and world trade should return to their more moderate 1987 growth rates.

However, the international pattern of growth will probably be somewhat less favorable for current account adjustment than was the case last year. Thus, while the external adjustment process is expected to continue in real terms in key countries, further large reductions in major current account imbalances are not anticipated this year.

The available evidence suggests that, while inflationary pressures bear close watching in some countries, the average industrial country inflation rate will pick up only modestly this year, to just below 4 percent. There is little evidence that a serious general acceleration of inflation is developing.

o Expansion Continuing at a Sustainable Pace

Real GNP rose 4.2 percent (annual average) in the seven largest economies in 1988. Expectations earlier in the year that the stock market break of October 1987 would have serious negative repercussions on industrial country macroeconomic performance were not borne out by events. Indeed, consumer and business sentiment improved substantially and generally remains good.

In addition to being stronger than initially anticipated, industrial country growth in 1988 was also better balanced internationally and therefore more supportive of global current account adjustment. In the United States, domestic demand growth was more moderate (3.0 percent) than in the earlier years of the current expansion, thus helping reduce the growth rate of nominal imports and making domestic productive capacity available to meet substantially higher foreign demand for U.S. products. The sharp improvement in U.S. net export performance last year accounted for nearly 1 percentage point of last year's 3.9 percent total GNP growth rate.

The Japanese economy, conversely, was led by a sharp increase in domestic demand while the external side exerted a strong net contractionary effect. Despite tax cuts in Germany, domestic demand growth was only slightly above GNP growth, and external developments had an essentially neutral impact. In the remaining major industrial countries, the difference between domestic demand and GNP growth was somewhat larger than was the case for Germany, particularly in the United Kingdom.

Growth prospects for the industrial countries remain favorable for 1989. GNP growth is projected to return to a more moderate and sustainable 3 to 3-1/2 percent range as private consumption growth moderates slightly and fixed investment slows from last year's exceptional pace. Japan will again be the G-7 growth leader for both GNP and domestic demand. In Europe, the growth slowdown is expected to be particularly evident in Germany and the United Kingdom.

The basic composition of industrial country growth outside of the United States this year (i.e., domestic demand growth in excess of GNP growth) is expected to be qualitatively similar to 1988. However, the projected slowdown of consumption and investment implies a more measured pace of domestic demand growth, which will narrow the amount by which it exceeds GNP growth.

o <u>External Adjustment at More Measured Pace</u>

One of the most favorable aspects of global economic developments in 1988 was the sharp increase in world trade growth, which both resulted from and contributed to the stronger and more balanced overall growth performance. The latest IMF estimates indicate that world trade volume increased by 9.3 percent in 1988 after a healthy 6.1 percent gain in 1987. This strong advance largely reflected developments in the industrial countries, which account for nearly 75 percent of total world trade.

These trade developments were reflected in significant shifts in the current account positions of major countries and country groups. The U.S. current account deficit declined about $20 billion, while Japan's surplus declined $7.5 billion and the combined surplus of the four Asian NIEs by about $4-1/2 billion, despite sharp growth in Korea's surplus. Europe's aggregate current account surplus was reduced by roughly $20 billion, though this was accounted for almost entirely by a very sharp increase in the deficit of the United Kingdom; Germany's current account surplus rose nearly $4 billion to a large record high of around $48-1/2 billion.

External adjustment in the major countries can also be gauged by considering current account imbalances as a percent of GNP, which eliminates valuation problems associated with exchange rate changes and takes into account the differing sizes of national economies. By this measure, the U.S. current account deficit declined from its 1987 peak of 3.4 percent of nominal GNP to 2.8 percent last year; Japan's surplus dropped from 3.6 to 2.8 percent (vs. its 1986 peak of 4.3 percent). Germany's surplus remained unchanged at 4.0 percent of GNP, though this was down somewhat from its 1986 peak of 4.4 percent.

Two emerging trends suggest, however, that while global current account adjustment is expected to continue this year, the pace of adjustment may slow somewhat. First, the projected narrowing in the difference between domestic demand and GNP growth in the major surplus countries will tend, ceteris paribus, to reduce the macroeconomic impetus for large additional shifts. Second, while U.S. export growth strengthened substantially in 1988, so too did export growth rates in most of the other major industrial economies, including the major surplus countries.

o Inflation Remains Modest and Contained

Consumer price inflation in the major industrial countries averaged about 3.1 percent in 1988, only slightly higher than the 2.8 percent recorded in 1987. Rates in Japan and Germany were exceptionally low, even by historical standards, averaging around 1 percent. France continued its impressive progress, holding its inflation rate below 3 percent. Rates in the United States and Canada both averaged near 4 percent, and around 5 percent in Italy and the United Kingdom.

Inflation rates in the major industrial countries have increased somewhat during the past 6 months, generating concern in some quarters about a potential serious deterioration on the price front. Average inflation in the industrial countries is expected to rise only modestly this year, however, probably remaining below 4 percent. While the situation bears close attention in some countries, some factors suggest that there is not now a serious risk of a general acceleration of inflation.

First, slower GNP and domestic demand growth this year will ease some of the demand-side pressure that may have been emerging last year. Second, and related to this, monetary authorities in the key countries have been pursuing policies of restraint. Third, despite some recent increases, unit labor cost developments have been quite moderate. Fourth, the OECD-wide surge in investment last year should help ease production bottlenecks that may be emerging in particular sectors.

U.S. Trade and Current Account Developments

o Developments in 1988

The U.S. trade deficit peaked in real terms in late 1986, and a year later in value terms. It then declined markedly in 1988.

The improvement in the U.S. trade deficit (nominal terms) in 1988 was broadly-based in geographical and product terms, and involved substantial increases in exports and slower import growth. For 1988 as a whole, the trade deficit declined by roughly $34 billion, from $160 to $127 billion, as exports grew strongly (28 percent in value terms), while imports grew less than one-third as fast. In volume terms, exports were up 23 percent, while imports increased 7 percent.

The trade deficit in 1988 decreased with every major geographic area, with the strongest declines vis-a-vis Western Europe, Latin America, and Japan. The improvement also covered a wide range of products. Only consumer goods, among major product groupings, failed to show a reduced defict in 1988.

Strong export growth was broadly-based in terms of both product categories and geographic regions. Past exchange rate changes played a major role in enhancing U.S. competitiveness in 1988. Our export competitiveness was complemented by strong domestic demand growth in industrial countries -- especially Japan -- and a revival of exports to Latin America, particularly to Mexico.

The more subdued rate of import growth for the United States in 1988 reflected in part the lagged effects of past exchange rate changes and lower average oil prices. Auto and consumer goods imports increased only slightly in 1988; a surge in these two categories had been a major contributor to the widening of the trade deficit during 1983-87. Capital goods was the one product category registering strong import growth in 1988, reflecting strong capital equipment spending by U.S. firms.

The pace of improvement in the trade balance, however, slowed in the last half of 1988. After remaining essentially flat at fourth quarter 1987 levels through the first three

quarters of 1988, import growth picked up in the fourth quarter of 1988, largely in finished manufactures. Export growth, though still robust, moderated somewhat in the latter part of 1988. Exports in the first half of 1988 were up over 32 percent in value terms from the first half of 1987, while second half exports were up 24 percent from the same period in 1987.

The U.S. current account deficit also declined in 1988, though less dramatically than the trade deficit, falling by roughly $20 billion, from $154 to $135 billion. This outcome reflected the net effect of the trade balance improvement discussed above, and a switch from surplus to deficit on trade in services. The adverse shift on the services account reflects the fact that the traditional U.S. surplus on investment income has been eroded, along with the U.S. international investment position, as borrowing from abroad has been needed to finance continued U.S. external deficits. (See Table 2.)

With respect to capital flows, the recorded net inflow in 1988 declined by about $17 billion, roughly equal to the decrease in the current account deficit. This was accompanied by a substantial shift from official to private net inflows. Official net inflows declined in 1988, while overall private inflows were unchanged. Within private capital, direct investment and securities transactions registered an increased net inflow, while banking inflows declined. By category, the largest changes in non-official flows were: increased foreign purchases of U.S. Treasury securities, more than offsetting a decline in purchases of other U.S. securities; a substantial decline in U.S. direct investment outflows; and a significant increase in net lending abroad by U.S. banks. (See Table 3.)

o Prospects for 1989

In view of recent developments, including higher oil prices and other factors, improvements in the U.S. trade deficit for 1989 which had earlier been expected may be partly offset. The outlook for trade and current account adjustment through the end of this year will be influenced by a number of major factors, in addition to oil prices. These factors include the prospects for sustained growth abroad, especially in Europe; exchange rate developments; progress with Korea and Taiwan on market opening and exchange rate adjustment; and sustained growth in major LDC export markets.

At home, success in reducing the budget deficit will be a critical counterpart to progress in these other areas. The recent bipartisan agreement on a budget framework for Fiscal Year 1990 between the President and the joint leadership of the Congress represents an important step in meeting the deficit reduction targets of the Gramm-Rudman-Hollings law.

Economic Policy Coordination

The major industrial countries are continuing their efforts to coordinate economic policies to achieve shared objectives. The coordination process has now become an accepted feature of the international economic landscape with regular meetings of finance officials from the Group of Seven countries (United States, Japan, Germany, France, United Kingdom, Canada, and Italy). A sign of the growing maturity and acceptance of the G-7 process, for example, was demonstrated by the meeting in February where no communique was issued and without the market instability that would have followed such a development in the past.

The recent meetings of the G-7 in February and again on April 2 have focused on efforts to maintain the substantial progress achieved in 1988 in dealing with global economic problems. Last year represented a notable success for the coordination process, as documented in the October report. Economic growth exceeded expectations and inflation remained in check. External imbalances were reduced substantially and exchange markets were generally stable.

However, sustained noninflationary growth -- which remains the central objective of the coordination process -- will require continued efforts. The success of these efforts depends on continued progress in controlling inflation and gradually reducing external imbalances. While reductions in external imbalances were achieved last year, further progress in this area is required.

- Countries with large fiscal and trade deficits, especially the United States, but also Canada and Italy, need to make further reductions in budget deficits to complement monetary policies. Implementation of the recent bipartisan budget framework agreement between the President and the joint Congressional leadership will be crucial to achieving further reductions in the U.S. budget deficit.

- The major surplus countries should pursue economic and structural policies that will sustain domestic demand growth without inflation and facilitate external adjustment; and

- All countries need to pursue structural reforms.

The coordination process has resulted in more effective arrangements to deal with exchange market pressures. As discussed in the next part of the report, exchange markets have been more stable over the past year, thus contributing to and benefitting from the progress in sustaining the global expansion

and reducing external imbalances. The G-7 agreed at their April meeting that a rise of the dollar which undermined adjustment efforts, or an excessive decline, would be counterproductive and reiterated their commitment to cooperate closely on exchange markets.

PART III: FOREIGN EXCHANGE MARKET DEVELOPMENTS

Overview

During the last 6 months, exchange markets have been generally stable. The dollar appreciated by about 5 percent against the Japanese yen and 4 percent against the German mark, but on a trade-weighted basis in nominal terms is little changed against major currencies. (See Table 4.)

Trends in exchange markets over this period can be subdivided into three distinct periods: 1) from October through mid-December when the dollar experienced selling pressure; 2) from mid-December through March when the dollar strengthened; and 3) since the beginning of April when the dollar eased from its end-March highs, but continues to be in good demand. Trading conditions throughout the period were influenced primarily by developments and market expectations regarding U.S. economic growth, inflation, monetary policy, and interest rates.

In market intervention, the U.S. monetary authorities made net purchases of about $0.7 billion from October through January. They purchased about $2.6 billion ($2.0 billion against yen and $0.6 billion against marks) to support the dollar against selling pressure during October-December, and sold about $1.9 billion against German marks in January as the dollar rose.

October through Mid-December

The dollar started declining in early October following evidence of slowing U.S. economic activity, which the market regarded as reducing the likelihood of monetary tightening. By mid-October, selling pressure on the dollar had emerged in response to diminishing prospects for higher dollar yields and market perceptions that U.S. monetary authorities might tolerate a gradual easing of the dollar ahead of the election, particularly because of concerns that adjustment of world trade imbalances was slowing. Furthermore, private analysts suggested that it would take a further dollar decline to narrow the U.S. external deficit. After the election, market attention shifted to concerns about the U.S. budget deficit, stimulating further dollar selling. Concerted intervention purchases of dollars by G-7 monetary authorities during the period made the market cautious about selling the dollar aggressively.

Mid-December through March

In December market sentiment changed, with participants taking the view that the G-7 monetary authorities would concentrate more on adopting anti-inflationary policies. Economic indicators showed that U.S. economic activity, though

moderating, remained robust. Dollar demand quickened on the market's belief that the Federal Reserve would tighten its monetary stance further. At mid-month, the Federal funds rate rose from under 8-1/2 percent to near 9 percent. However, in view of coordinated interest rate hikes in Europe, interest differentials favoring dollar placements against European currencies initially narrowed. There was no appreciable change in interest differentials against the yen.

Toward mid-January, the market turned increasingly bullish on the dollar. There was growing optimism regarding the United States' willingness to tackle its fiscal deficit. Also, "safe haven" demand related to tensions in the Mediterranean was appreciable. Meanwhile, comments from various G-7 officials were interpreted as indicating a tolerance for further dollar appreciation. Reports of concerted intervention sales of dollars during January and early February braked the dollar's upward momentum.

Subsequently, additional data interpreted as suggesting that inflationary momentum may have increased in the United States encouraged further expectations of monetary tightening by the Federal Reserve. Chairman Greenspan said that the Federal Reserve would err on the side of monetary restraint. The Federal Reserve progressively tightened the Fed funds to levels over 9 percent and, in late February, raised its discount rate by 1/2 percentage point to 7 percent. Meanwhile, Germany and Japan signalled that they would avoid further tightening of their monetary stances. Interest differentials against the German mark and the Japanese yen then began to widen significantly and, by late March, were approximately 1/2 percentage point higher than in late February.

Since End-March

After reaching its highs for 1989 in late March, the dollar eased back in early April. Following the G-7's statement of April 2 and subsequent reports of intervention sales of dollars against yen as well as marks, the market perceived that the G-7 monetary authorities would regard further dollar appreciation as counterproductive to global adjustment of external imbalances. Also, prospects for a further widening of interest differentials in favor of the dollar were viewed by market participants as mixed, given that U.S. economic indicators were seen as pointing tentatively to moderating U.S. economic activity.

Effects of Exchange Rate Changes on External Positions

Despite recent movements, the dollar remains roughly at 1980 levels in real terms. On average, the appreciation of the dollar in the early and mid-eighties against our major trading partners has been reversed.

Exchange rate changes since October have, on balance, been minor, and exchange rate changes in any case tend to influence the real economy with considerable lags. Thus, exchange rate developments over the past months probably have not been a significant factor affecting the U.S. economic situation and prospects. The influence of such minor exchange rate changes is extremely small, in comparison with the potential overall impact of other factors influencing the trade and current account position.

The October report noted several factors not captured by conventional models which could contribute to sustained reduction of the trade deficit over the long term. Strengthened competitiveness is much broader based than exchange rate calculations show. Intense competitive pressures during the period of dollar strength forced U.S. producers to make fundamental changes resulting in increased efficiency, reduced costs, and improved quality.

Also, direct investment in the United States should contribute to the adjustment process over time, especially in the automotive sector, with Japanese firms in particular expanding U.S.-based output (for export as well as import replacement), product lines and value added. However, the favorable indirect effects of past exchange rate changes on the trade balance resulting from direct investment activity are of a long-term nature. The modest exchange rate movements over the past 6 months have probably not affected these developments.

Finally, most trade models are based on assumptions of no policy changes. The essence of the G-7 coordination process is that policies are regularly reviewed, with an eye to possible changes in light of developments in the underlying fundamentals. The G-7 are committed to implementing the policies necessary to build on the progress that has been achieved.

PART IV: ASIAN NEWLY INDUSTRIALIZED ECONOMIES (NIEs)

Overview

The U.S. merchandise trade deficit with the Asian NIEs -- Korea, Taiwan, Hong Kong, and Singapore -- was $29.2 billion in 1988, 16 percent below 1987. This development reflected decreases in the bilateral deficits with Hong Kong (down 21 percent to $4.6 billion) and Taiwan (down 26 percent to $13 billion). As a share of the total U.S. trade deficit, the trade deficit with the NIEs increased slightly from 22 percent to 23 percent.

However, as noted in the last report, if the imbalance with Taiwan is adjusted to account for $2.5 billion (customs value) in gold Taiwan imported from the United States in the early part of 1988 for the purposes of diversifying official international reserves and reducing the imbalance, then the trade deficit with Taiwan fell by only 11 percent to $15.5 billion.

Under Section 3004 of the 1988 Trade Act, the Secretary of the Treasury is required to "consider whether countries manipulate the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." It was concluded in the October 1988 report that Taiwan and Korea engaged in such "manipulation," within the meaning of the legislation. Pursuant to Section 3004, the Treasury was required to initiate bilateral negotiations with Taiwan and Korea for the purpose of ensuring that these two economies regularly and promptly adjust the rate of exchange between their currencies and the U.S. dollar to permit effective balance of payments adjustment and to eliminate the unfair advantage.

Below is a summary of economic and exchange rate developments in Korea and Taiwan and the negotiations which have taken place with them since October. (See Table 5 on U.S. trade with Asian NIEs and currency changes.)

Korea

- o Recent Exchange Rate Developments

The October report to the Congress and subsequent initiation of exchange rate negotiations with the Korean authorities stimulated a period of more intense appreciation of the won in late 1988.

- o In the fourth quarter of 1988, the Korean authorities allowed nominal appreciation of the won to total 5.1 percent, compared with 2.5 percent and 1.3 percent in the second and third quarters.

o Most of this fourth quarter movement occurred in October and November, with the pace of appreciation slowing substantially in December.

Cumulative won appreciation in 1988 totalled 15.8 percent. This exceeded the movement against the dollar in 1988 of the currencies of Korea's key trade competitors, Japan and Taiwan. Thus, in 1988, the Korean won began for the first time to lose on a broad basis some of the advantage that it had gained for Korea earlier in the decade, and particularly since 1985.

Despite the won's strengthening in 1988, cumulative won appreciation still lagged behind that of the yen and New Taiwan (NT) dollar in key periods. For example, in the interval from the Plaza Agreement in September 1985 to end-1988, the won appreciated 34 percent against the U.S. dollar, compared with 49 percent for the NT dollar and 83 percent for the yen. Thus, the won maintained an important, albeit diminished, competitive edge.

In 1989, the authorities have generally maintained the slow pace of appreciation that they resumed in early December 1988. Won appreciation in the first quarter of 1989 totalled only 1.8 percent. However, late March and early April saw a brief period of somewhat more rapid movement of the won as the Treasury Department intensified its negotiations with Korea and the deadline approached for this report. Thus, as of mid-April, the won had appreciated 2-1/2 percent in 1989.

o 1988 Bilateral U.S. Trade Deficit with Korea

According to U.S. customs data, the United States bilateral trade deficit with Korea increased 1 percent in 1988 to $9.0 billion, reflecting a 39 percent increase in U.S. exports to Korea and a 19 percent increase in U.S. imports from Korea. This is significantly slower growth than in 1987 when our bilateral trade deficit increased 39 percent (from $6.4 billion to $8.9 billion), based on a 27 percent rise in exports to Korea and a 33 percent rise in imports from Korea.

In the second and third quarters of 1988, the U.S. bilateral deficit with Korea was actually somewhat lower than in the same quarters in 1987. These declines were due primarily to a drop in the rate of growth of U.S. imports from Korea. This, in turn, was largely the result of the temporary impact of labor disturbances in Korea on production and exports. Growth in the bilateral deficit resumed in the fourth quarter of 1988, registering an increase of 5 percent over the fourth quarter of 1987.

o Korean Global Balance of Payments Developments in 1988

Korea's 1988 global trade surplus increased 51 percent to $11.6 billion on a balance of payments basis. Overall, exports grew 15 percent in volume terms, down from 24 percent in 1987. The growth of import volume, however, decreased even more sharply to 10 percent from 22 percent in 1987.

Toys are the only category of Korean exports that declined in value terms in 1988 (by 7 percent). Textiles and footwear -- other labor-intensive products about whose competitiveness the government expresses concern -- managed increases of 22 percent and 25 percent, respectively, despite won appreciation and higher wages. Exports of higher value-added products performed even more strongly: electronics were up 33 percent, iron and steel 35 percent, machinery 51 percent, automobiles 20 percent (despite second quarter labor disturbances), and ships 55 percent.

Korea's 1988 current account surplus increased 44 percent to $14.3 billion, compared with the government's $7 billion target. Thus, for the third consecutive year, the actual current account surplus was more than double the government's initial target for the year. Increases in net services and transfers -- reflecting declining external interest payments, Olympics-related tourism revenues, and transfers from Korean residents abroad -- contributed to the swelling of the current account surplus.

As indicated in Part II above, the magnitude of external imbalances is best judged by presenting the amount as a percentage of GNP. In this context, it is noteworthy that Korea's trade surplus increased from 6.5 percent of GNP in 1987 to 7.4 percent in 1988, while the current account surplus increased from 8.3 percent of GNP in 1987 to 9.1 percent in 1988. In contrast, Japan's 1988 trade surplus was equal to 3.3 percent of its GNP and its current account surplus, 2.8 percent, both having declined from 1987 to 1988.

With the rapid expansion of its current account surplus in 1988, Korea was able to continue reducing its external debt and building its foreign reserves, further strengthening its international position. Gross external debt fell to $31.2 billion (20 percent of GNP) in 1988, compared with $35.6 billion (30 percent of GNP) in 1987 and $46.8 billion (55 percent of GNP) in 1985. In addition, Korea increased its foreign reserves by nearly $9 billion to $12.3 billion in 1988; although equal to about 3 months' imports, this level is not excessive.

o Domestic Economic Performance

Korea's economy continued to boom in 1988. Real GNP growth exceeded 12 percent for the third consecutive year, bringing cumulative real GNP growth to 41 percent since end-1985. Domestic demand is strengthening -- due to large nominal wage increases, lower tariffs, and cuts in excise taxes -- but increased real net exports still accounted for nearly 50 percent of real GNP growth.

Unemployment averaged only 2.5 percent in 1988, the lowest annual average in the last three decades. Wages have increased by about 33 percent in the past 2 years. Cumulative productivity gains among production workers totalling about 30 percent in the past 2 years have largely offset the higher wages.

Monetary and price developments are increasingly showing the negative side effects of Korea's external imbalance. Despite tight credit controls and the government's direct efforts to sterilize the liquidity resulting directly from Korea's massive external surpluses, money supply expanded by about 19 percent in 1988. This, together with the large nominal wage increases and emerging capacity constraints, was largely responsible for the jump in inflation from 3 percent in 1987 to 7.2 percent in 1988.

o Trade Developments in 1989

Preliminary Korean customs data for the first quarter of 1989 show a substantial decline in Korea's global trade surplus relative to the same period in 1988. These data indicate that the global trade surplus totalled only $95 million in the first quarter of 1989, compared with $1.4 billion in the first quarter of 1988. Moreover, the won value of Korean exports declined by 4 percent in January and by 8 percent in February relative to the same periods in 1988, although in U.S. dollar terms, Korean exports increased by 11 percent and 6 percent, respectively, given the increase in the dollar value of the won in 1988.

For January-February 1989 (the latest period for which U.S. customs data are available), the U.S. bilateral trade deficit with Korea declined 28 percent, compared with the same period in 1988. U.S. exports to Korea increased 29 percent, while imports from Korea declined by 1 percent.

It is likely that Korea's first quarter trade performance reflects a compounding of seasonal factors (the first quarter is traditionally the weakest quarter in the trade account) and other unique influences:

- Korean exporters accelerated shipments in the fourth quarter of 1988 in anticipation of continued strengthening of the won.

- Korean importers, for their part, delayed clearing goods through customs in anticipation of the January 1, 1989, tariff cuts.

- Together, these factors helped swell the 1988 fourth quarter trade surplus and produce an abnormally low surplus in the first quarter of 1989.

- The increased level of labor disturbances so far this year is also temporarily suppressing Korea's export performance.

These seasonal or temporary factors notwithstanding, the preliminary data for early 1989 probably also reflect the beginning of a reduction in the underlying imbalance -- perhaps a significant reduction. Previous appreciation of the won, coupled with inflation and some trade liberalization, may have begun to contribute to a welcome structural reduction in Korea's external surpluses.

- Evaluation of Recent Developments

The won's appreciation against the U.S. dollar in 1988 was significant and reflected Korea's recognition of the need for the exchange rate to play a role in the adjustment process. The accelerated appreciation of late 1988, after negotiations were initiated, and more recently in the last few weeks, was a welcome response to our concerns. Nevertheless, cumulative won appreciation remains insufficient, judged against the magnitude of Korea's external surpluses in the past 3 years and the much greater appreciation of the currencies of Korea's competitors in the same period.

Korea's exchange rate policy this year appears to be based on the assumption that the trade data for the first quarter of 1989 foreshadow a drastic reduction in Korea's surpluses for the year as a whole. The indications that structural reduction in these surpluses may have begun are both welcome and hopeful. Nevertheless, the data are too preliminary and limited to indicate clearly such a trend, and in our judgment, do not justify the sharp deceleration in the pace of appreciation in most of the period since early December 1988. While some moderation in the pace of appreciation relative to the fourth quarter of 1988 appears understandable in the circumstances, continued appreciation of the won during the period ahead is nonetheless required to reinforce recent trade developments and ensure that the preliminary, first-quarter reduction in Korea's external surplus is, indeed, the first stage in a structural and lasting correction of the imbalance. If final trade data for the period ahead also show significant reductions in Korea's external surplus, the need for further won appreciation would be diminished.

The Treasury Department's negotiations with the Korean authorities since the October report appear to have produced some results. Cumulative exchange rate appreciation, however, remains insufficient and assurances of further appreciation that could be considered sufficient in the circumstances are lacking. In addition, Korea has not provided indications that it intends to move to a market-based system of exchange rate determination over the medium-term. Nor is Korea willing to engage in broader discussions on financial market liberalization. Thus, our judgment is that, within the meaning of Section 3004 of the Omnibus Trade and Competitiveness Act, Korea continues to "manipulate" its currency.

Our negotiations in the coming months will be aimed at obtaining assurances that exchange rate policy during the period ahead will reinforce the direction of recent trade developments. We will also seek to encourage the Korean authorities to dismantle the comprehensive capital and exchange controls that prevent market forces from asserting themselves in exchange rate determination.

Taiwan

Taiwan's external imbalances have undergone further positive adjustment since the last report. This is due, in large part, to the effects of currency appreciation, further reductions in trade barriers, and rising inflation and wages. If all of these elements, particularly further appreciation, continue this year, we would anticipate an additional reduction in Taiwan's current account surplus and its bilateral trade surplus with the United States in 1989.

Taiwan's global current account surplus also decreased by 43 percent in 1988 to $10.2 billion. As a proportion of GNP, this translates into a sizeable decline from 18.4 percent in 1987 to 8.3 percent in 1988. At the same time, Taiwan's overall trade surplus, excluding official gold imports from the United States, fell 26 percent in 1988 to $13.8 billion ($10.9 billion, including U.S. gold).

In the first 3 months of this year, compared with the same period last year, Taiwan's overall trade surplus was lower by 23 percent, excluding U.S. gold, but up 9 percent including U.S. gold. Moreover, domestic demand has replaced exports as the main source of growth for the economy. Real GNP growth was 7.3 percent in 1988, down from 11 percent in 1987.

Large U.S. exports of gold to Taiwan through August 1988 accounted for more than half of the reduction in the U.S. bilateral deficit with Taiwan. These exports have ceased and need to be replaced with an even greater value of other sustainable exports if the adjustment process is to be furthered

in 1989. In the last 6 months for which U.S. data are available (September 1988-February 1989), the average monthly trade deficit with Taiwan (excluding U.S. gold exports) has fallen 21 percent from the same period a year ago. Nonetheless, annualizing these data results in a trade deficit larger than last year's, or $13.9 billion. Clearly, this is still an unsustainable imbalance.

The New Taiwan (NT) dollar has strengthened by 49 percent against the U.S. dollar since the Plaza Agreement in September 1985, compared to 83 percent for the yen, 53 percent for the German mark, and 34 percent for the Korean won. However, in 1988 the NT dollar depreciated through October. Since the October report, the exchange rate has appreciated by 6-1/2 percent, mainly in 1989. Such currency appreciation is a positive development. Nonetheless, given the still large trade imbalance and the lack of currency appreciation throughout most of 1988, it appears that a continuation of the recent appreciation is required to advance the adjustment process.

During our recent negotiations with Taiwan (under the auspices of the American Institute in Taiwan and Coordination Council for North American Affairs) regarding its exchange rate policy, Taiwan agreed to take a number of important measures, including liberalizing its foreign exchange system and reducing capital controls. This liberalization could represent a potentially important step toward the establishment of a more market-based system of exchange rate determination.

It remains, however, too early to assess fully the effects of these measures. The effectiveness of the liberalization will depend importantly on how it is implemented and, specifically, on satisfactory resolution of uncertainties concerning: the extent of central bank intervention in the market; the continued free flow of trading information; the removal of remaining controls on capital inflows; and the potential for discrimination between Taiwanese and foreign banks. If these potential difficulties are promptly and fully addressed, the liberalization could be a major advance. If not, the new system could regrettably involve little real progress toward exchange rate liberalization.

o Description of New Exchange Rate System

Taiwan began to implement the new exchange rate system on April 3. Formerly, the NT dollar's value against the U.S. dollar was determined by the "middle rate" of interbank transaction rates on the previous business day, with a limit on fluctuation. The most important aspect of the new system is that all NT dollar-U.S. dollar transactions of $30,000 and above will now be freely determined. The exchange rate for small retail transactions under $30,000 will be determined by rotating

groups of nine foreign exchange banks (including foreign banks) based on the prevailing free market rates. Banks can then decide the exchange rate for small transactions based on this "reference rate." If the transacted rates fluctuate in excess of a certain level, then a new "reference rate" is determined with a wider band.

Given that the central bank could still intervene in the foreign exchange market through proxy state-owned banks, a significant reduction of central bank direct and indirect intervention will be essential to allow adequate scope for market forces. However, as announced and initially implemented, the new system does not permit openly ascertaining the level of official intervention. The Central Bank is using five local banks for intervention and information regarding transaction amounts and transaction banks will no longer necessarily be made available as it was in the past. Although the need for some discretion by the Central Bank is understandable, given the relatively small size of Taiwan's foreign exchange market, it need not have come at the expense of a normal degree of transparency for the system.

There are other operational problems with the new system. First, limits have been retained on banks "short" foreign exchange positions. Moreover, additional new limits were imposed on "long" foreign exchange positions. Initially these limits discriminated against foreign banks. Moreover, although foreign banks are to participate in the committee that determines the "reference" exchange rate, this has not yet appeared to be the case. We have indications that Taiwan intends to correct these problems, and will monitor the situation.

We are encouraged by the new foreign exchange system, which could potentially limit intervention. But, as noted above, its significance depends on its implementation. While we also welcome the appreciation of the NT dollar since the beginning of our negotiations, this appreciation, if not continued, will be insufficient against the backdrop of the lack of appreciation throughout most of 1988, which impeded the adjustment process. Therefore, further appreciation, of a sufficient magnitude, will be necessary this year.

Therefore, at this time, we are not yet able to alter our basic judgment that Taiwan, within the meaning of the legislation, "manipulates" its exchange rate. With full implementation of the new system, however, and further adequate exchange rate appreciation, it would be possible to review our position on this matter. Our negotiations in the period ahead will be aimed at prompt resolution of the problems that could limit the effectiveness of the new system as well as obtaining further sufficient appreciation of the NT dollar. It is important that Taiwan's currency more accurately reflect market forces and its external surpluses.

PART V: CONCLUSION

This report has provided an update of developments since October 1988, when the first report on international economic and exchange rate policies was submitted to the Congress.

Global economic performance has remained favorable in the intervening period. The economic expansion is continuing in the major countries, with the seventh year of consecutive growth following an extremely robust performance in 1988. Furthermore, in 1988, the lagged effects of exchange rate changes in 1986 and 1987 and the composition of demand in the major countries were conducive to significant reductions in external imbalances.

The pace of external adjustment has slowed, however. In view of recent developments, including higher oil prices and other factors, improvements in the U.S. trade deficit for 1989 which had earlier been expected may be partly offset. While inflationary pressures bear close watching, there is little concern that a general acceleration of inflation is developing.

The economic policy coordination process has contributed importantly to the improved performance of the global economy in the current expansion. Sustained noninflationary growth remains the central objective of the coordination process and will require continued efforts in reducing fiscal deficits, controlling inflation and gradually reducing external imbalances. In the United States, the recent bipartisan budget framework agreement between the President and the joint leadership of the Congress represents an important step forward in these efforts.

During the past 6 months, exchange markets have been generally stable. The dollar has appreciated slightly against some major currencies, but has been broadly stable on a trade weighted basis. These exchange market developments have, at most, had only a marginal impact on U.S. trade performance and would not be sufficient to change the outlook. The relative stability of exchange rates has made a welcome contribution to, and been supported by, the progress in sustaining global expansion and reducing external imbalances. The G-7 major industrial countries have agreed that a rise of the dollar which undermined adjustment efforts, or an excessive decline, would be counterproductive, and they have reiterated their commitment to cooperate closely on exchange markets.

In the October report, it was determined that Taiwan and Korea, within the meaning of the Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, were "manipulating" their exchange rates against the U.S. dollar to prevent effective

balance of payments adjustment or gain unfair competitive advantage in international trade. In accordance with that section, the Treasury initiated bilateral negotiations with Korea and Taiwan for the purpose of ensuring that they regularly and promptly adjust the rate of exchange between their currencies and the U.S. dollar to permit effective balance of payments adjustment and eliminate the unfair trade advantage.

The appreciation of the Korean won since 1988 has been significant, and coupled with inflation and some trade liberalization, may have begun to contribute to a welcome structural reduction in Korea's external surpluses. Cumulative appreciation of the won, however, remains insufficient in view of Korea's overall economic performance and the large gap that exists between the appreciation of the won and that of the currencies of its major competitors. Korean authorities have slowed the won's rate of appreciation so far this year on the belief that first quarter trade data for 1989, showing a substantial decline in Korea's global trade surplus, portend a drastic reduction for the year as a whole.

In our judgment, these trade data are too limited and preliminary to indicate a clear irreversible trend towards a structural reduction in Korea's surpluses. Although, the Treasury Department's bilateral negotiations with Korea have produced some results, assurances of further adequate exchange rate appreciation are lacking. Moreover, Korea shows virtually no willingness to move to a market-based system of exchange rate determination over the medium-term nor to engage in broader discussions on financial market liberalization. Thus, within the meaning of the legislation, Korea continues to "manipulate" the won. Continued bilateral negotiations with Korea in the period ahead will be aimed at assuring adequate exchange rate cooperation in the near-term. Also, Korean authorities will be encouraged over the medium term to dismantle the comprehensive capital and exchange controls that prevent market forces from asserting themselves in exchange rate determination.

Taiwan's bilateral trade surplus with the United States and global current account surplus have declined. The NT dollar depreciated in 1988 through October, but has since appreciated somewhat. While this appreciation is welcome, further appreciation of a sufficient magnitude is required to advance the adjustment process, given the continued large trade surpluses and the lack of appreciation throughout most of 1988.

Taiwan's new foreign exchange system is an encouraging development, which could potentially limit intervention. The significance of the new system will, however, depend on its full implementation, and uncertainties exist as to the prospects for continued heavy central bank intervention to limit appreciation. Therefore, the basic judgment cannot yet be altered that Taiwan, within the meaning of the legislation, "manipulates" its

exchange rate. With full implementation of the new system and further sufficient exchange rate appreciation, we may well be in a position to review this judgment. Negotiations in the period ahead will aim at prompt resolution of the problems that could limit the effectiveness of the new system as well as obtaining further sufficient appreciation of the NT dollar.

APPENDIX

TABLES

1. Economic Performance of Key Industrial Countries

2. Summary of U.S. Current Account

3. Summary of U.S. Capital Account Flows

4. Measurements of Dollar Movements Versus G-7 Currencies

5. U.S. Trade with Asian NIEs and Currency Changes

Table 1

Economic Performance of
Key Industrial Countries 1/

	GNP Growth 2/		Domestic Demand Growth 2/	
	1987	1988	1987	1988
U.S.	3.4	3.9	3.0	3.0
Japan	4.5	5.7	5.2	7.7
Germany	1.8	3.4	3.1	3.7
France	2.3	3.4	3.4	3.7
U.K.	4.3	4.4	4.3	6.2
Italy	3.1	3.7	4.6	4.1
Canada	4.0	4.2	4.7	5.1
G-7 3/	3.4	4.2	3.7	4.4

	Inflation 4/		Current Account 5/	
	1987	1988	1987	1988
U.S.	3.6	4.1	-3.4	-2.8
Japan	0.1	0.7	3.6	2.8
Germany	0.2	1.2	4.0	4.0
France	3.3	2.7	-0.5	-0.4
U.K.	4.1	4.9	-0.6	-3.1
Italy	4.7	5.0	-0.1	-0.5
Canada	4.4	4.0	-1.9	-1.5
G-7 3/	2.8	3.1		

1/ All data are latest IMF figures, except for U.S.

2/ Real growth rates, annual average.

3/ Average of individual country rates weighted by GNP in dollar terms; annual averages.

4/ Consumer prices; annual averages.

5/ Calculated as percent of GNP; negative indicates deficit.

Table 2

SUMMARY OF U S. CURRENT ACCOUNT
(MILLIONS OF DOLLARS, S.A.)

	Quarters								Annual		
	87:1	87:2	87:3	87:4	88:1	88:2	88:3	88:4	1986	1987	1988
Total Exports	56791	59864	64902	68014	75140	79443	81674	83648	223969	249570	319905
Agricultural	6486	7118	8287	7626	8910	9547	10213	9598	27357	29516	38268
NonAgricultural	50306	52746	56615	60387	66230	69896	71461	74050	196612	220054	281637
Total Imports	96662	99416	104567	109205	110327	109595	110844	115664	368516	409850	446430
Petroleum	8760	10075	12759	11288	9960	10257	9838	9236	34391	42883	39291
Non-Petroleum	87902	89341	91807	97917	100367	99337	101006	106429	334125	366967	407139
TRADE BALANCE	-39871	-39553	-39665	-41191	-35187	-30152	-29170	-32016	-144547	-160280	-126525
Partial Bal (Excl. Ag Exps & Pet Imps	-37597	-36596	-35192	-37529	-34138	-29441	-29545	-32379	-137513	-146914	-125503
Net Services	5214	1025	678	12042	1336	-885	-222	4548	21027	19759	4777
Invest. Income	5076	1692	1067	12539	1128	-1986	-1234	4694	23143	20374	2602
Other Services	138	133	-389	-497	208	1101	1012	-146	-2116	-615	2175
Total Transfers	-2967	-3125	-2980	-4373	-3147	-2777	-3215	-4444	-15309	-13445	-13583
Remits & Pension	-867	-884	-855	-820	-908	-819	-872	-932	-3571	-3434	-3531
Govt Grants	-2100	-2241	-2125	-3545	-2239	-1958	-2343	-3512	-11738	-10011	-10052
NET INVISIBLES	2247	-1300	-2302	7669	-1811	-3662	-3437	104	5718	6314	-8806
CURRENT ACCOUNT	-37624	-40853	-41967	-33522	-36998	-33814	-32607	-31912	-138829	-153966	-135331

Source: Survey of Current Business

Table 3

SUMMARY OF U.S. CAPITAL ACCOUNT FLOWS
(MILLIONS OF DOLLARS, S.A.)

	Quarters								Annual		
	87:1	87:2	87:3	87:4	88:1	88:2	88:3	88:4	1986	1987	1988
US Reserve Assets (Incr(-)Decr(+))	1956	3419	32	3741	1503	39	-7380	2272	313	9148	-3566
Other Govt Assets	67	-170	252	1012	-814	-801	1990	3266	-1999	1161	3641
Foreign Official Assets	13977	10332	611	20047	24670	5946	-2534	10930	35507	44967	39012
Industrial	16561	17533	-926	16063	20814	6839	-3314	5557	29379	49231	25896
OPEC	-2801	-2681	-1723	-2750	-1375	-1783	-466	715	-9327	-9955	-2909
Other	217	-4520	3260	6734	5231	890	1246	4658	15455	5691	12025
Banks, net:	15770	-4461	29634	6304	-125	17847	1394	2268	19808	47247	21384
Claims	21870	-22422	-16519	-23460	17108	-13274	-27832	-33495	-59975	-40531	-57493
Liabilities	-6100	17961	46153	29764	-17233	31121	29226	35763	79783	87778	78877
Securities, net	13908	13479	9012	-6238	4795	16783	9806	7985	70481	30161	39373
Foreign Securities	-1639	-88	-972	-1757	-4467	1529	-1554	-2982	-4297	-4456	-7474
U.S. Treasury Securities	-2826	-2431	-2035	496	6887	5457	3412	4130	3809	-7596	19886
Other U.S. Securities	18373	15998	12819	-4977	2379	9797	7948	6837	70969	42213	26961
U.S. Direct Invest. abroad	-10691	-6220	-7870	-19676	-6509	511	-5196	-9241	-27811	-44457	-20435
Reinvested Earnings	-8663	-4932	-6300	-15776	-3636	-1525	-5519	-8749	-19708	-35671	-19429
Equity & Inter-co. Debt	-2028	-1288	-1570	-3900	-2873	2036	323	-492	-8103	-8786	-1006
For. Direct Invest. in U.S.	7979	7229	15026	11742	7347	13061	8395	13420	34091	41976	42223
Reinvested Earnings	1645	736	2081	-1925	3345	1093	1882	852	-2294	2537	7172
Equity & Inter-co. Debt	6334	6493	12945	13667	4002	11968	6513	12568	36385	39439	35051
Other U.S.-Corp., net	1205	4173	-331	248	1700	-6948	2399	n.a.	-7126	5295	-2849
Claims	-491	2603	-215	1248	-315	-7061	749	n.a.	-4220	3145	-6627
Liabilities	1696	1570	-116	-1000	2015	113	1650	n.a.	-2906	2150	3778
NET CAPITAL FLOWS	44171	27701	46366	17180	32571	46438	8874	30900	123264	135698	118783
Statistical Disc.	-6547	13071	-4399	16342	4428	-12624	23733	1013	15565	18467	16550
TOTAL *	37624	40852	41967	33522	36999	33814	32607	31913	138829	153965	135333

Source: Survey of Current Business

Table 4

Measurements of Dollar Movements
Versus G-7 Currencies Since Key Dates
Percent dollar appreciation (+) or depreciation (-)

as of April 12, 1988

Value of the dollar in terms of:	Since Floating Began 3/20/73 to date	Since Dollar Peak 2/26/85 to date	Since Previous Report 10/14/88 to date
Japanese yen	-49.6	-49.2	+4.0%
German mark	-33.2	-45.7	+3.5%
Sterling	+45.8	-38.3	+3.3%
French franc	+40.8	-40.0	+2.4%
Canadian dollar	+19.2	-15.3	-1.5%
Italian lira	+144.3	-36.3	+1.8%

Source: London midday rates.

Table 5

U.S. TRADE WITH ASIAN NIES AND CURRENCY CHANGES

U.S. Trade Deficit with Asian NIEs [1]
(U.S. $ Billions)

	1980[2]	1987[2]	1988[2]	%Change[3]
Hong Kong	-2.1	-5.8	-4.6	121%
Korea	0.2	-9.4	-9.5	n.a.
Singapore	1.1	-2.1	-2.2	n.a.
Taiwan	-2.8	-17.5	-13.0	369%
TOTAL NIEs	-3.6	-34.8	-29.2	722%
Total U.S.	-25.5	-160.3	-126.5	397%
% Total U.S.	14%	22%	23%	

[1] Totals may not equal sum of components due to rounding.
[2] U.S. balance of payments adjusted data.
[3] From 1980 to 1988.

Cumulative Change against US$ as of April 11, 1989 [1]

from:	7/22/80	9/20/85	end-87	10/14/88[2]	Rate on 4/11
HK$	-37.88%	0.41%	-0.30%	0.40%	HK$ 7.78
Won	-11.87%	34.01%	8.70%	6.41%	W 667.5
Singapore$	8.04%	12.49%	1.92%	3.28%	S$ 1.96
NT$	32.72%	49.39%	5.26%	6.55%	NT$ 27.12
¥	66.02%	82.51%	-6.84%	-4.72%	¥ 132.68
DM	-7.89%	53.07%	-15.32%	-4.30%	DM 1.89

[1] This table is calculated in terms of the movement of the foreign currency against the U.S. dollar, as this is the way the Asian NIEs measure their foreign currency movements. Thus, foreign currency appreciation is represented by a (+) and depreciation by a (-).
[2] Date of last foreign exchange report to Congress.

The CHAIRMAN. Well, Mr. Secretary, I know you must leave in just a minute. I want to note that Senator Bond has arrived and simply say that it looks that way to us as well. This committee worked very hard to craft these provisions and get them into the trade bill and, of course, they only have a meaning if the Treasury Department takes and uses that tool, as you have, and I think we do see signs of progress.

I want to just ask you one thing before you leave. As our Trade Ambassador, Carla Hills, approaches the designation of countries under the Super-301, which she's got to do by the end of this month, will the Treasury be making its thoughts known to her? You folks are directly involved in aspects of this.

Secretary BRADY. Well, obviously Ambassador Hills has the lead role and the definitive role in the 301 determinations, but we have a process—the Economic Policy Council—inside the White House which does give Ambassador Hills the benefit of other departments views—State, Treasury, Commerce, Agriculture, all of the Council of Economic Advisers, OMB—everybody who has an input into this particular problem is asked for their opinion and she's very vigorous in getting those opinions and, as you say, she has the responsibility of coming up with that report by the end of May and I think we have a meeting scheduled on this matter with Ambassador Hills in the middle of May. So the answer to the question is, yes.

The CHAIRMAN. Very good. I know you must leave at this time. We thank you again for coming and we would be pleased to carry on the discussion with Under Secretary Designate Mulford in your absence.

Secretary BRADY. Thank you, sir.

The CHAIRMAN. Thank you.

Let me just ask Senator Bond, did you have an opening comment that you wanted to make at this point?

Senator BOND. Thank you, Mr. Chairman. I will save my comments for the question period.

The CHAIRMAN. Very good.

Mr. Mulford, I want to just say at the outset something related to our discussion yesterday in the Finance Committee. We have two members of this committee that are also members of the Finance Committee, Senator Heinz and myself. It's obvious to me that with the sweeping change that's going on in the global economy we no longer have nice, orderly dividing lines as to what separates one thing from another. We are finding that here in the area of exchange rates. Even in the trade bill itself, which was principally written by the Finance Committee, there are provisions that were in fact written by the Banking Committee, and so we continue to find that we have mixed issues and mixed relationships.

I want to say to you at the outset that as you prepare to embark on your new responsibilities that this committee fully intends to properly assert itself in the international financial arena I think to a far greater extent than we may have in the recent past.

JURISDICTION

We will do so because of the need to move in that area. So I would look forward not only to hearings that we will conduct but

to discussions that we will be able to have informally. I know several members of the committee have a very deep interest in that part of the committee's jurisdiction and so I want you to view today as a very limited beginning of a much broader and deeper and stronger relationship going back and forth. We are seeing the same thing with respect to one of your colleague designates also, Mr. Glauber, who we have been dealing with on the savings and loan issue and a host of other issues. So where banking ends and finance begins and finance ends and banking begins is really not a clear-cut division any longer.

In any case, we are going to look forward to developing that relationship and seeing if we can't come up with some good strategies that we can all participate in that will make some progress for us.

I would like you to pick up where the Secretary's statement has left off. Well, before I do that, Senator Sarbanes is also under some pressure this morning because of matters that he has to attend to in another setting. I'm going to yield at this point to you, Senator Sarbanes, so that you can have your question period at this point.

Senator SARBANES. Thank you very much, Mr. Chairman. I appreciate that. A matter has come up back in my State that will require my presence and it's very helpful to me.

I am concerned by the story that appeared in the press I guess yesterday with respect to the comments of the South Korean Deputy Prime Minister who is also the Minister of Economic Planning, with respect to the adjustments in the South Korean exchange rate. Of course, there's a very high probability that South Korea may in fact be designated under the 301 procedure as well as a priority practitioner of unfair trade practices.

MANIPULATING THE EXCHANGE RATE

I guess the first question I would put, is it understood when you are in discussions with these countries that are manipulating the exchange rate that practices of that sort—exchange rate manipulation or unfair trade practices in the trading regime, perhaps even discrepancies on the burden-sharing—have a very marked impact on the attitudes in the Congress toward the trading relationship?

It's one thing for the Congress to withstand protectionist pressures and keep on the path of open and fair trading if it can be presented that at least the framework is a fair one and there's a difficulty here in terms of competition. It's quite another thing to expect the Congress to stay on the path of an expanding open international trading environment if in fact nations are manipulating their currency to gain an advantage, establishing unfair trade practices in order to help them on their balances, not fully sharing in the burdens of perhaps a common defense arrangement.

I wonder if the broader impact of these manipulations are understood in terms of how they affect certainly I think members of the Congress, who of course are reflecting attitudes in the country?

Mr. MULFORD. Well, I think the answer to that is that the understanding is growing, although it's been slow in growing. As you will remember, we began our discussions with Korea on the matter of currency in the latter part of 1986 when it became obvious after the Plaza agreement that the currency adjustments that were

taking place among the major currencies were not being followed by certain other countries, including Korea. Our efforts met with very little success. We applied ourselves continuously during that period attempting to make the very points that you have been making. And as the Secretary said, I think we got a major assist from you when you and your colleagues designed this language which, you may remember, we discussed in great detail at the time and which was aimed at trying to improve the coordination process between nations but also trying to improve the coordination and consultative process between the executive and legislative branches.

Once that was done and the report technique, for example, became part of our working arrangements, it's given us a great deal more ability to focus their attention with some greater credibility on the breadth of these issues that you have mentioned.

So it's early days. We've had that extra tool, if you want to call it that, since late last year, and the results have already been fairly good.

Senator SARBANES. Well, I think it's important for these nations to understand the congressional attitude toward the imbalance in the trading figures is obviously going to be impacted markedly if there's a perception that underlying that is currency manipulation being done in order to gain unique advantage for the country doing it.

The other problem, of course, is that if other countries—Taiwan and earlier you had mentioned Japan—allow their exchange rate to adjust and perhaps Korea does not, they gain an advantage then with respect to Japan and Taiwan. Of course, the consequence of that is then I would think to put pressure on in those countries not to be forthcoming on the exchange rate adjustments because they say, well, here's a country that's not following this path and they're gaining an advantage over us.

Do you discern that kind of danger?

Mr. MULFORD. That has been a major problem all along, that the four NIC's, as we've approached any one country in the case of Korea and Taiwan in particular, have often pointed at the other countries' currency levels and said, "You can't ask us to take these steps without additional steps being taken by the others because that places us at a disadvantage, et cetera," that's been a major problem. But again, I think the focus of the effort assisted by the report and by the sort of growing concentration of the total administration effort on Korea and Taiwan is having results.

Senator SARBANES. Well, I think the reports are enormously helpful and in fact I think the fact that my own questioning this morning has tended to focus on South Korea, not on Taiwan, reflects the fact that the reports submitted by the Treasury makes a distinction between the two countries in terms of the extent to which they have tried to address this very important issue.

Mr. Chairman, I very much appreciate your courtesy in allowing me to go first and I do want to thank Secretary Mulford for his efforts in this and in other areas. I think this is a very important issue and it's obviously one that the committee and I think members of the Congress will be following very closely. There's another report due on October 15, so there's another 6-month period that

now runs and we will have a chance then to revisit this issue and see what further progress has been made.

The CHAIRMAN. Very good. Thank you, Senator Sarbanes.

Senator Pressler.

IMPACT ON AGRICULTURAL PRODUCTS

Senator PRESSLER. I want to just follow that up by pursing this a bit.

Are agricultural products more sensitive to exchange rate manipulation than other products? Is there a greater degree of elasticity for some products than others?

Mr. MULFORD. Well, that's a difficult question to answer, the question of elasticity, but obviously exchange rates are very, very important for the overall adjustment and agriculture is an important part of the economy in each case.

Senator PRESSLER. What leverage do we have on a country such as Korea which, according to this article in the Washington Post, just resists the pressure to boost its currency. When we get some adjustment of tariff barriers, countries come up with nontariff barriers, such as inspections or marketing gimmicks, but maybe more subtle and more extreme is the ability of some countries to manipulate their exchange rates.

What pressure can we put on them? How can we get them to let their exchange rates float or cooperate with what the rest of the world is doing?

Mr. MULFORD. Well, there's a variety of possibilities. Those include, of course, such things as Super-301 listing and actions taken under that, if that does in fact happen, in various specific trade fields. And the Koreans are very sensitive to those specific areas of interest.

Senator PRESSLER. Well, for example if we did move under Super-301 with respect to Korea, what would be the first thing that would happen?

Mr. MULFORD. Well, I suppose there would be a concentration on certain particular product areas and areas of business activity. We would not take the view in the Treasury that we should use the 301 process specifically for currency operations because there are a number of disadvantages that would be associated with that that we would have to see clearly as a last resort before we'd turn to.

Senator PRESSLER. Let's say we came up to that last resort. I'm just trying to get some education here. What would be some of the things, for example, that could happen?

Mr. MULFORD. Well, first of all, you would go through a long process in which you would attempt to negotiate with the country. I think it's something like 18 months. If that was unsuccessful, then retaliatory arrangements would have to be worked out and it's difficult at this moment to be specific on what they might be.

Senator PRESSLER. For example, what might they be?

Mr. MULFORD. That really would be a USTR prerogative and I would not wish to get into designing those.

Senator PRESSLER. But based on your general knowledge, what might some of them be?

Mr. MULFORD. They might be actions taken by this country to limit access to our markets, for example.

Senator PRESSLER. Well, I hope that we move toward some of these things and we make it clear that we will move toward some of them because I see a world in which we are the good guys, so to speak, in some of these more subtle areas of currency exchange rates, and we have bent over backward. It seems to take so long to get any movement in these areas, and to be so much hesitation.

Also, I said—and I guess I upset the Secretary of Agriculture a little—that I felt that in the European negotiations we had been a little soft when it came to agricultural trade policy. That is not the case here because exchange rates apply across the board to all of our products, but I think it's an area that we have to make clear that we will retaliate, that we will move quickly. This is my judgment and maybe you can expand upon this.

For example, with South Korea, what steps will be taken if they continue to resist pressure to boost their currency? What steps will Treasury take?

Mr. MULFORD. Well, the first thing we will do is attempt to engage them again on the question of currency, on the question of access to their financial markets, and on the question of the openness of their financial markets. We will also engage them in discussions about broad macroeconomic policies, structural changes in their economy and so on.

If these talks are relatively successful——

Senator PRESSLER. These talks would last 18 months?

Mr. MULFORD. No. These are talks that have been going on. We have engaged them in the past and we will continue to do so in the future. And in particular, so far as the Treasury is concerned, we are interested in access to their financial markets and the development of capital markets within Korea, including the liberalization of their internal banking and securities markets and so on.

These things, if we can make some progress, will have an effect on the exchange rate. It is not just a question of asking the Korean authorities to move the exchange rate. Obviously that's part of it and we will continue on that front as well because they do control the exchange rate today. But we will seek to have them alter their exchange rate mechanism toward greater freedom and make the other changes that I have mentioned in an effort to transform their economy to some extent so that the exchange rate can more freely reflect the economic fundamentals.

Senator PRESSLER. Yes. I'm not criticizing you at all, and I was one of those who voted for the Super-301 procedures I hope that our Government will use those procedures and make it clear that we will get started quickly.

It's always hard to explain to the man on the street—that we can't do these things overnight and there must be talks and there must be a period of 18 months and so forth, but there is a clamoring at the grass roots with the growing understanding of international trade in our country. When you speak to the Kiwanis Club in Sioux Falls, there's a growing feeling that we are being overly generous in these subtle areas. The exchange rate issue is one of them. And I urge you and the administration to make it clear that you are going to use the powers that Congress has given you.

Indeed, that was our purpose in amending section 301 of the 1974 Trade Act. I just wanted to express that.

Mr. MULFORD. May I just make one more remark?

The CHAIRMAN. Yes.

Mr. MULFORD. I think it's important to point out that the progress with Korea on the exchange rate has been picking up. It's not as if they've failed to make any sort of move whatsoever. Since last October, for example, when this report was first required, they have moved their exchange rate approximately 12 percent. During the period since the Plaza, in September 1985, the total movement in their exchange rate has been 57 percent—I'm so sorry—they have moved their exchange rate 6.5 percent since last October and the total exchange rate moved since the Plaza has been 34 percent. So something like 20 percent of the movement has been accomplished just since the beginning of last year, which I think shows that the rate of improvement has been picking up.

Senator PRESSLER. Let me ask this. I'm not just picking on Korea. What other countries have been the worst offenders, in your opinion?

Mr. MULFORD. The other country that stands out has been Taiwan, but again, there's been substantial progress there.

Senator PRESSLER. Who are the three or four worst offenders besides Korea and Taiwan?

Mr. MULFORD. Those are the two worst offenders. The other countries that we wish might have done better are Singapore and Hong-Kong, but their approach is entirely different. They do not manipulate their exchange rates. We did not make that judgment. It's only in the case of Korea and Taiwan that we made the judgment on manipulation.

Senator PRESSLER. And after those four, which countries? Any in Europe?

Mr. MULFORD. No, because in Europe and Japan we have a floating exchange rate system which for the most part reflects market fundamentals.

Senator PRESSLER. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Pressler.

Secretary Mulford, manipulation of exchange rates is obviously just one part of the trade deficit problem that has become so large and persistent in the United States. For a moment I'd like to widen out and a look at the whole trade deficit and how it changes to our overall debt position.

OUR NET FOREIGN DEBT

Our net foreign debt is now about $500 billion. I was struck by the fact that there's no mention of that in the report whatsoever.

But leaving that aside, observers who are really watching these trend lines are estimating that we will probably hit a figure of about $1 trillion in net foreign debt somewhere around 1992. It's obviously a radical change in circumstance for the United States in the context of the world economy.

I'd like to ask you your own view. As we ride that trend line into that deeper sort of net debtor position, can we just do that indefinitely? Is there some point at which that becomes threatening in

new ways to us or becomes unsustainable? What are the implications of just continuing to plunge down into that debtor's hole?

Mr. MULFORD. Well, that's an extremely difficult question to answer with any degree of accuracy because it's heavily judgmental and it involves the judgments of not only economists of all kinds—which as you know they never agree—but a wide variety of market participants around the world who would be making judgments about continuing investment in the United States, whether they have confidence in our economy as it stands at any given time, and how they view that burden of debt and so on.

So with that general proviso understood, I would be happy to express my personal opinion on the subject, which is that one of the reasons that we worked so hard on developing more effective policy coordination between the major trading countries and on similar sort of issues with countries like Korea and Taiwan which are major trading nations, is that we must find ways to adjust the large external imbalances which presently exist in the world economy.

This includes our trade and current account deficits, and the very large surpluses which exist in Japan, Germany, Korea, Taiwan and so on. There are both international and domestic elements to that process. Domestic policies need to be adjusted in all the countries and in our case, of course, that means that we need to continue making progress on the reduction of our fiscal deficit. We must continue to give very high priority in our economic policy to the international objective of continuing adjustment of external imbalances.

We made progress in 1988. We are making some progress now. But it's absolutely vital, in my view, that we continue to give that high priority because ultimately the United States really cannot sustain a growing indebtedness without paying potentially a heavy price at some point. Nobody knows where that point would be. Nobody knows the events that might bring it about. But clearly, if you are heavily indebted over a long period of time, you are faced with the constant burden into the future of servicing that debt or making good on it at some point in the future. And if that burden becomes too heavy and too long-lived, then it also becomes a major political problem in the sense that you're talking about the capacity of the country to exercise leadership in the world and so on.

So in the long run it's a very serious problem and it underlines, as far as I'm concerned, why we must continue to give priority to this process and continue to work in the direction of adjusting these external imbalances.

The CHAIRMAN. Let me ask you this. Isn't it fair to say that our prevailing interest rates today in the United States are higher than those that most of our main trading competitors are having to deal with because we have to attract far more capital than do they in order to finance our deficits, both the fiscal deficit and in effect the trade deficit as well?

Mr. MULFORD. Well, I think it's very difficult to really answer the question the way you've put it to me because it makes it look single dimensional.

The CHAIRMAN. That's not my intention. Obviously, I wish we had a single dimension problem here we could deal with.

Mr. MULFORD. What you've said has an element of truth in it, but it's not the only factor that affects interest rate levels in the United States and I think it's important to point out that we attract investment into the United States by virtue of our strong and positive economic performance. It's not just a question of high interest rates being necessary to attract capital. I think that one has to balance both those factors.

JAPANESE SELL UNITED STATES GOVERNMENT BONDS

The CHAIRMAN. I hear that, but let me make a specific reference to one thing here. In the March-April issue of the Harvard Business Review there is an article entitled, "Power Without Purpose: The Crisis of Japan's Global Financial Dominance." I don't know if you've had a chance to see that article, but in that article it quotes Secretary Brady as attributing the October 1987 stock market crash to an interest rate rise caused by the fact that the Japanese sold off enormous amounts of United States Government bonds because they believed the exchange rate value of the dollar was going to decline in light of the just released August 1987 trade figures.

Now that is a story that takes an appraisal from the Secretary, of course, who's just left us.

Now it seems to me that if we are not in a situation where we're having to bid up interest rates in order to attract this tremendous inflow of foreign borrowing that we now rely on, then why wouldn't interest rates be lower than they are today?

Mr. MULFORD. Well, I think one can——

The CHAIRMAN. I mean, other things being equal, the fact is that it has driven up interest rates, or would you assert that that's not the case?

Mr. MULFORD. I would assert that that's not the case in a direct sense because I would harken back, for example, to the period earlier in the 1980's when we had very high interest rates and we did not have a deficit of this size. We were not an indebted country at that point and yet we had very high interest rates. So obviously interest rates are influenced by a lot more elements than just the magnitude of our trade deficit, current account deficit, or the size of our in debtedness internationally. I mean I think it's an extremely multifaceted issue and it's very hard to isolate one thing.

The CHAIRMAN. Well, I would agree with that point, but I think to take the extraordinary interest rates when we were—at that time Volcker was trying to cope with an inflation emergency—that I think is something of an anomaly and I don't know that it's fair to take that and use that as a basis for saying we are not in a box now where we are paying higher interest in an international arena because of the fact that we're having to attract so much foreign borrowing to finance deficits that we can't otherwise finance. We are in that situation.

It seems to me if you relate it to the earlier point, if we find ourselves owing the rest of the world a trillion dollars by 1992, other things being equal, we're probably going to be paying even higher differential interest rates on a global scale than we are today. I don't find that a very appetizing future.

Mr. MULFORD. I think one can think about another future. For example, if there's progress made in deficit reduction, that should improve prospects for domestic savings which should in turn improve prospects for lower real interest rates. That might take place during a period, say, of the next year without a complete elimination or even a major improvement in our imbalances. So I do think there's a lot more to this than the single proposition that you're pressing here, if I could say so with due respect, although I agree with the point you're trying to make that if you become excessively dependent on foreign capital for too long a period of time, it is true that you have in a way less to say over the terms that are going to be imposed on you for continuing to attract that capital. I think there's validity in that point.

The CHAIRMAN. Well, I would hope that we would start to consider that issue in terms of where we are on that trend line. We were a net creditor nation as recently as 1984, and now we have passed everybody on the debtor nation list and are on our way to a trillion dollar international debt within probably 3 year's time. Real interest rates are very high here, in comparison just with Japan, with their prime rate somewhere around 2 percent or thereabouts at the present time. Maybe it's closer to 3 percent, but there's an enormous differential. I think we're in trouble. But I agree with you that this is not one dimensional. It's more than three dimensional and that's part of our problem.

Senator Bond.

MARKETPLACE DISCIPLINE AFFECTING OUR MONETARY POLICY

Senator BOND. Thank you very much, Mr. Chairman.

Mr. Mulford, to follow up on the discussions you've been having with the chairman, I have seen some authorities say that really the United States has now passed into an era where we are so dependent upon foreign borrowing that international debt holders really are the factor which guide our monetary policy, that we now owe so much abroad and have to finance so much that we now have a marketplace discipline that is affecting our monetary policy probably at least as much as the Federal Reserve and we have in fact gone from a monetary system controlled by the Federal Reserve to one controlled by the international financial markets.

What's your personal opinion on that assessment?

Mr. MULFORD. I wouldn't say that it is controlled by the international financial markets as opposed to the Federal Reserve. I think the Federal Reserve still is in charge here of our monetary policy. But obviously the changes that have taken place in recent years in world financial markets are very, very important. Many of them have been very positive. They've had to do with deregulation in various markets, the removal of barriers, the freer movement of capital, and these things can be very, very beneficial. In fact, I would argue that if you look back, say, 15 years, that we could not have had the kind of world growth that we've enjoyed and the adjustments that we've managed to make to such things as the oil embargo and price movements, movements of financial resources, without the kind of exchange rate system and opening financial markets that we've had.

As you may know, I've had a lot of experience in the investment field internationally with regard to official reserves because I did that job in Saudi Arabia for many years. There are elements of the United States markets that are very attractive and that no other market in the world has and one can't underestimate that. So it is not just a question of the United States being so desperate that it needs to attract foreign capital. Foreign capital is also attracted to us, seeking a place where the market is free, vast, diverse, deep, easy to deal in, great liquidity. That's not true in Germany. It's not true in Japan to anything like the same extent.

Therefore, with the dollar being paramount in the world and the United States market really being completely different than any other market in the world, it's natural to expect a great deal of investment flow here. So it's very hard to separate out how much of that is fetched, as it were, by higher rates and so on, and how much of it is attracted by the sheer dimensions and attractiveness of our own market.

Senator BOND. Well, I wasn't saying that the management or the dependence upon international financial markets was necessarily bad. In fact, the person who postulated that theory said that this might give us a sufficiently finely tuned monetary policy that we would escape any significant recessions or downturns.

But with respect to the capital coming into this country, is it fair to say that our savings rate is so low that we barely save enough to meet our private investment needs and in fact that when you put the budget deficit on top of that the only source for the borrowing that we must have to finance our continued deficit is the international capital markets. Aren't we forced to bring in that component?

Mr. MULFORD. Well, you could put it that way, that a part of it we're forced to, I suppose, and clearly the answer here it seems to me to both questions is the need to continue to emphasize rather quickly as a matter of urgency further reduction in our fiscal deficit which should improve our savings situation and lead to further adjustment in the right direction.

Senator BOND. Let me ask you a personal question. You have great background and experience in international markets. We have just womped through budget resolutions in the House and the Senate. In the Senate we stayed pretty close to the outlines of the agreements worked out by the administration and Congress.

Do you think those agreements are going to send any kind of positive signal to the G–7 and to other sophisticated participants in international markets, or do they see it as smoke and mirrors?

OUR COLLEAGUES IN THE G–7 REMAIN SKEPTICAL

Mr. MULFORD. I think that it has sent a positive signal already and that it was a very important move to make as early as we made. However, foreign markets and, of course, our colleagues in the G–7 remain skeptical. They want to see how it's actually put into place, like everybody else.

Senator BOND. I'd say there are some in Congress who might even share that skepticism.

Mr. MULFORD. Therefore, it's going to be very, very important, exactly how we deliver on this over the next few months.

Senator BOND. Finally, is the dollar now at the level we are going to have to keep it to attract the borrowings? Do you see any significant possibility or need for changes in the level of the dollar?

Mr. MULFORD. Well, I won't want to comment on any specific level of exchange rates, but the exchange rates we've had in recent months and the relative stability in exchange markets has been welcome to us. We've seen adjustments take place. Although the dollar has strengthened a little over the last 6 months, adjustment is continuing, although at a slower pace.

Senator BOND. If I may impose to ask one very brief question——

The CHAIRMAN. Sure.

Senator BOND. Do you think maintaining those exchange rates should become a primary focus of monetary policy and of Treasury action?

Mr. MULFORD. You mean maintaining the specific exchange rate?

Senator BOND. Within a range.

Mr. MULFORD. Well, I think that the exchange rate levels that we've seen among the major currencies over the last year or so, and on which we cooperate closely, have been widely accepted in the market. As things stand now, it would seem to me that we should not attempt to greatly change that situation.

You may remember a statement made in early April by the G–7 ministers which made the point that a rise in the dollar that would disrupt the adjustment process or an excessive decline in the dollar would be counterproductive. That would be our present position today.

Senator BOND. Thank you, Mr. Mulford.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

I want to repeat again, as I said earlier, that Senator Heinz was really a key force in developing this provision of the trade bill which has its meeting here today and that was important work and it's having an effect. I yield to Senator Heinz.

Senator HEINZ. Senator Riegle, thank you very much. I appreciate those kind words but there were other members of this committee, such as Senator Sarbanes and others, who were active in that, too. This is a matter of great interest because one of the things that determines the competitiveness of a country, either in getting into a market or in the ability to keep people out of a market, is the exchange rate which operates in a variety of ways, as we well know.

I am delighted that David Mulford is here, that Nick Brady was here. I commend them on their report. It is a very important, useful report. It is, in general, well done, and it highlights some very difficult and thorny problems that we're going to be dealing with for a long time.

We have seen a variety of protectionist practices by many countries. We have over the last decade endeavored to attack those practices using multilateral GATT-sanctioned devices. As we have gone through that process, many countries—particularly the Pacific Rim countries, the NIC's, Korea, Taiwan, Japan—have found new and very innovative, if not commendable, ways of circumvent-

ing the system. And in your report you have put your finger in particular on Taiwan and even more heavily your thumb on Korea for engaging in a pattern of capital controls and currency manipulation that has proved both very beneficial to them at the expense of many others, ourselves, of course.

HOW DID KOREA ACHIEVE ITS CURRENCY MANIPULATION?

I'd like to ask you, Mr. Mulford, to elaborate beyond what is in the Treasury report on exactly how Korea has achieved its currency manipulation. What have they done in terms of capital controls that have manipulated the currency?

Mr. MULFORD. Well, this question is a fundamental one. It's a very difficult one. It's what makes writing the report difficult. Let me do my best to try to indicate to you how we make that judgment.

First of all, the situation in a country such as Korea or Taiwan would be characterized by an economy that is export-led in its growth, that is generating strong growth, that is generating a large surplus, but is characterized in the exchange markets by several things. One, very large-scale intervention by the central bank in order to hold the rate at a particular level. Second, that is usually coupled with pervasive capital controls and administrative mechanisms which are aimed at preventing the exchange rate from reflecting market forces. That could take the form of exchange controls, for example, that are managed in a given way. That could be different in each country, but invariably there are pervasive controls involved.

And the fact that in the case of Korea and Taiwan, particularly in Korea as you mentioned, these elements are there and lead us to make that judgment. Usually, and this is certainly true in Korea, there is also a tendency to control the supply of currency. In other words, in Korea, the banks, some of which are American, simply can't get won in the market without going to the authorities. So there is really no way that a free market is allowed to even begin to operate under those circumstances because there is no market outside the hands of the authorities.

Senator HEINZ. Let me ask you a question about economics. If in fact a country does manipulate its currency, and it is able to keep its currency relatively cheap, thereby facilitating exports, doesn't that in effect allow a country which might otherwise have to dump—that is to sell below the domestic price in that country—to sell its goods competitively abroad to avoid dumping? In other words, can't they in effect substitute manipulation of exchange rates for dumping and achieve the same effect?

Mr. MULFORD. Well, the two certainly could be related, yes.

ANTIDUMPING ACTIONS

Senator HEINZ. If that is true, doesn't that make it more difficult for U.S. companies to bring antidumping actions against Korean companies, for example?

Mr. MULFORD. I suppose if you're saying that because of currency policies they enjoy an unfair advantage in a general way, it's harder to make a dumping accusation stick, yes, that's right.

Senator HEINZ. Let me put it in plain English. If Korean steel is selling here at, say, hypothetically $300 a ton at existing exchange rates, and let us say that because the exchange rates are favorable, because the won is manipulated to be weak, does that not mean that if the won was unmanipulated that a Korean manufacturer, in order to sell at $300—the competitive hypothetical price in our market—would have to engage in some other strategy to do it, such as dumping, in order to maintain that $300 price, all other things here being equal?

Mr. MULFORD. I'm not a specialist in the dumping field, but that sounds logical to me.

Senator HEINZ. By the same token, another way of looking at exchange rate manipulation is that it's an export subsidy.

Mr. MULFORD. Yes.

Senator HEINZ. Should currency manipulation of the kind you have described in your report be an export subsidy under U.S. countervailing duty law? It is not currently so considered.

Mr. MULFORD. I couldn't answer that off the top of my head. That's an issue we'd have to look at before giving an answer.

Senator HEINZ. What would be your views as to whether or not the administration should push for the categorization of currency manipulation, as we've been talking about it, as an export subsidy in the currently ongoing Uruguay round negotiation?

Mr. MULFORD. I think my reaction to that would be that it would greatly complicate the negotiation. It would perhaps make the currency problem harder to solve and it would tend, given what else has happened in this complex field of the GATT—a tendency for perhaps a situation which is short-lived to have a longer life because it is incorporated in some very technically complicated approach to the problem.

I made a comment earlier that I think it's important for us to keep negotiating with these countries and cure these situations. We are making progress. If you resort to more formal mechanisms, it seems to me you might actually suffer a setback in the speed with which you can accomplish this adjustment.

Senator HEINZ. I'm not sure whether you disagree with the idea of fighting on all courts—mounting an all-court press against currency manipulation through a multilateral process in principle, or whether you're objecting to that idea for tactical reasons; namely that the Uruguay round is already underway and the job that Carla Hills has is tough enough. I hope it's the latter. Because if it's the former, you are suggesting that all the efforts we put into the multilateral negotiations in the case of the Tokyo round and the subsidy code and the entire efforts that are now underway in the Uruguay round to make the subsidy code mean something are all misguided.

Mr. MULFORD. Well, my feeling is that it would not be the right approach to take currency issues, which are after all a worldwide problem, and just because a small number of countries manipulate their currencies, we then transform the entire approach we use in other areas. I think that would be a misguided approach. I think we're far better off to address currency problems as we do today around the world and to select those countries that have manipulated—as indeed we have—isolate them and attempt to negotiate

with them. I think that's a far more productive route to follow than attempting to sort of multilateralize the entire currency situation.

Senator HEINZ. Mr. Chairman, my time obviously has expired. I have other questions. I will wait my turn.

The Chairman. Senator Heinz, you've got a line of questioning going here. Why don't you just continue with it and take another time period and just go right on through.

Senator HEINZ. Mr. Chairman, thank you very much. I appreciate that.

It seems to me that when it comes to backing up anything that we do with multilateral approval, it helps. I was just in Japan last week and in Japan where they have a large number of practices that are extralegal—they have administrative guidance, they have regulations, they have regulations that are kind of written in disappearing ink—they are here today and when you try to find them they're gone tomorrow, but the effect lingers on. And when written on rice paper they reappear. Beyond that, there are business practices and customs which protect the market for goods and the market in currency.

The fact is that when I said to many people I talked to in Japan, "Well, how do you feel about the possibility or likelihood about being targeted under Super-301," the answer was, "Look, we've repealed all our laws. All we're doing is what we have been doing for a thousand years."

Now their view is that Super-301 is a unilateral mechanism, that we are wrong to single them out, that irrespective of the fact that the whole notion of multilateralism and the GATT and MFN is that within a world trading system that is open that, regardless of the reasons, one country should not play by such a different set of rules, practices and customs, that it gains from the system and everybody loses; or, if you will, impairs the benefits of that open trading system to all the other people who do play by an accepted set of rules. That thought is very alien in many Pacific Rim countries.

There's a good reason that it's alien. At Bretton Woods in 1943, certainly Japan was not a participant. It was the Allies that were participating. The Pacific Rim countries who now have sufficient stature to participate, weren't there. Korea and Taiwan were not there. Taiwan wasn't separate then. It was still a part of China.

As a result, there is no particular buy-in to these concepts and unless they are really established or you might say re-established, I fear that we're going to get into not just protracted negotiations but an endless process.

Let me move from that subject to my last question, which is one that I think Don Riegle has taken a great interest in, and it has to do with how this country can be competitive in the case of capital market manipulation, in this case not by Korea or Taiwan—not that I'm excusing them—but by Japan. In the case of Japan, an American or other company cannot go into its capital market and freely sell securities or raise capital by means of obligation—debt. All of that is very carefully, extremely strictly controlled.

JAPAN IS AWASH IN MONEY

As a result, Japan is awash in money, and the borrowers of it are kept at arm's length, and it is something of a joke. They now refer to Toyota Bank because there's no sense Toyota putting their money in the bank because they won't get much money for it. So they keep it.

Now the significance of that for the producers in Japan is that they have an extraordinarily low cost of capital. They are the only people who really have a demand for capital. There is so much of it that the long-term interest rates are 2½ percent, a pretty good deal. Two and a half percent is below the difference between what borrowers have to pay and the inflation rate in this country, the so-called real interest rate.

The price-earnings multiples on the Tokyo Stock Exchange are between 60 and 70 times earnings. If you adjust their accounting they might be around 30 or 35 times earnings—about twice what they are on the New York Stock Exchange. And that means that the cost of capital to their industries is very, very low and it is much lower—multiples lower—than it is to our companies here.

It seems to me that if labor, capital and management are, largely speaking, the three most important determinants of whether a country is competitive and if our country is not competitive by having sufficiently low cost of capital, then we are doomed.

And a country that succeeds in manipulating its markets to keep its cost of capital artificially low is guaranteed tremendous success.

My question is, does the Treasury Department recognize this problem? And if you do, what should we be doing about it?

Mr. MULFORD. Well, I will not respond with a long answer to that, but let me just say the following.

The Treasury recognized in 1984 the need to liberalize and transform the Japanese capital market and at that time we initiated discussions—the so-called yen-dollar talks—which were aimed at three things. They were aimed at internationalizing the yen. That is to say, making the yen a more usable currency worldwide for trade and investment. It was argued that would affect the exchange rate over time and make the yen reflect more accurately the fundamental strengths of Japan.

To cut a very long story short, that part of the negotiation was successful. The yen in international bond markets is now, for example, the number two currency of denomination. It's much more broadly held. It is not as widely used for trade as it might be. There's obviously room for it to be used more widely, but the transformation has been substantial.

The second area was to improve access for U.S. companies to the financial business in Japan and, again there, the record has been outstanding in terms of access to do business in those markets. I'm talking about financial organizations—banks, investment banks, asset managers, trading in government bonds in Japan, membership in the stock exchange and so on.

The third part of the effort was to engage Japan in a discussion about the liberalization or deregulation of their own domestic market. That is a truly gigantic task. It involved the kind of deregulation that we went through in the 1970's—deregulation of in-

terest rates, for example, changes in the way in which business is done—and there's been a great deal of progress there, although today I would estimate that probably 60 to 65 percent of deposits in Japan are still regulated. So there's a long way to go.

They also had, as you pointed out, many regulations that applied to their domestic bond market. Those also have been substantially changed, although not entirely removed.

I would be happy to come up and brief you more fully on the results of these talks. We are about to meet again with the Japanese. It's been a 5-year program.

And the aim here, in addition to internationalizing the currency which of course today is very strong—at the time we started it was undervalued in the eyes of the world. Now, depending on your view, certainly stronger. But we also have succeeded I think in changing the cost of capital. Now it may still be low, but Japanese savings are very large. The opportunities for those savers to invest are very limited in terms of market-based instrument. They are now much broader than they were before, but they are still limited. They are making progress all the time.

At the moment, for example, the giant postal savings organization is allowing little investors different kinds of rate treatment so that there's more competition and there will be a greater divergence and diversification of short-term investment.

It will take time, but the Japanese have committed to move in that direction and, frankly, the progress has been pretty substantial.

On one point of fact, the long-term bond rate in Japan is 5 percent approximately now, and not 1½ percent. So the differential between the United State long-term bond market—5 and 5½ percent in Japan and approximately 8.9 or 9 percent here—is not quite as substantial.

Senator HEINZ. The Japanese Government long-bond is 5 percent?

Mr. MULFORD. Well, I just checked. The rate in February was 5 percent. It's probably——

Senator HEINZ. This is long-term?

Mr. MULFORD. Yes.

Senator HEINZ. Well, I'm glad to know that. Let me respond this way, David.

We both know that there are a lot of agreements that Japan makes that look real good on paper or sound real good when you read about them in the paper. The semiconductor agreement being a case in point.

It is also another thing to overcome all the bureaucracy that stands between anything on paper and results. You said that results have been very encouraging, successful, outstanding, and I fear that the kind of results you're talking about are the results that negotiators come away from the table with, not the results that show differences in the marketplace, by and large.

Now I'd be happy to receive any additional information from you on that, but in terms of all the people I talk to there—American business people, securities people and others—their view and our Government's view of what's possible in Japan are very different, and they will tell you that it's just very difficult to get into the

bond market. They will tell you about all the other problems that there are that are in a sense extralegal.

INTERNATIONALIZING THE YEN

And in terms of internationalizing the yen—and I agree with you that's a vital goal—the biggest problem with internationalizing the yen is that for a currency to be international other people have to have the chance to earn it. Otherwise, it doesn't mean anything.

Don Riegle quoted from an article in the Harvard Business Review. I commend that article to you because the main substance of that article is about how Japan has all the characteristics that a reserve currency ought to have. There are a lot of yen. It is involved in a lot of trade. But, because nobody can earn yen because everybody runs such huge trade deficits with Japan and because the Japanese don't want to be a reserve currency because it implies certain kinds of responsibilities that they would rather not undertake, that all the progress that you are talking about, to my mind, is very much will-o'-the-wisp because until the currency is genuinely international in the sense in which that term is usually accepted, everything we're talking about is just marginal.

Mr. MULFORD. Well, could I just give you some——

Senator HEINZ. Please.

Mr. MULFORD. I'll have to do these numbers off the top of my head so they may not be entirely correct but I think they're pretty close.

When we began those talks, the volume of new issues denominated in yen in the Euromarket the previous year was about $1 billion. In the past couple of years it's been running in the $20 to $25 billion area. And as I said, the currency of denomination for international securities operations in the Euromarket, debt operations, the yen is now number two after the dollar.

Senator HEINZ. What is the volume of the dollar?

Mr. MULFORD. I don't know what the volume of the dollar is offhand.

Senator HEINZ. I would guess it's a tad larger than $25 billion.

Mr. MULFORD. It's substantially larger than that, that's true. But the movement in a short period of time has been very substantial.

Senator HEINZ. When I say a tad larger, I mean many, many, many, many multiples larger. The currency flows in the world today——

Mr. MULFORD. These aren't flows. These are just denominations of new issues.

Senator HEINZ. Well, I don't have enough information about denominations, but I do know that currency flows, depending on how you measure them, are up in the $20 to $30 trillions a year. Now how much of that is in the form of Eurodollars, Euroyen, I don't know, but $25 billion anything is a drop in the bucket.

Mr. MULFORD. Well, I just would have to beg to disagree with that on the basis of financing. You're talking about the sort of daily rollover of large transactions. I'm talking about actual financings. It's a different concept.

Senator HEINZ. Well, you would have a stronger case if you would compare it to Eurodollars.

Mr. MULFORD. Well, I think the best thing to do might be to come up and see you and give you data and go through this because I do feel very strongly that to characterize the progress of the last few years in this area as will-o'-the-wisp is not accurate and I would be happy to come up and debate that with you and bring the data to do it.

Senator HEINZ. My time has long since expired and I feel that's probably a far better way of doing it, but as with many of our negotiators who work very hard—and you have worked very, very hard over the years and I commend you for all the work you've done—I fear our negotiators—and it's true of us when we negotiate something with each other or the House or with the White House—we tend to believe we've won more than we really did. And I hope and trust that that's not the case with you, although since we're all guilty of it I don't see why you shouldn't be.

Mr. MULFORD. Well, I don't suffer from overestimating in that way. I know we've got a long way to go, but the point I'm making here really is that if you approach Japan on a micro-basis, product by product, I think you'll accomplish a lot less than if you approach it on a macroeconomic basis in the first place, seeking major structural changes of the type I've tried to outline in the financial markets or attempting to, through negotiation, find ways to convince the Japanese themselves that they should change. Indeed, in the financial area, the changes that have taken place in recent times have been generated by them because they see the advantage to be gained by deregulating their own financial markets.

Senator HEINZ. Thank you very much. Mr. Chairman, I'd still like to have my complete prepared statement inserted in the record at this point.

STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I want to welcome Nick Brady to the committee for the first of what I hope will be many discussions over the years on exchange rates and international economic policy.

Public debate of these issues is long overdue, given their critical impact on the U.S. economy.

If we had started this dialog 10 years ago, we might have avoided the roller-coaster ride of the dollar and stagnation of U.S. exports from 1982 to 1986 from which we are still trying to recover.

I would like to focus a few brief comments on the major problem cited in the Treasury report—the abusive exchange rate practices of Korea and Taiwan.

For the second time, Treasury has made the finding that they are "manipulating their exchange rates to gain unfair competitive advantage in international trade."

And you have to be impressed at the good job they are doing. We tend to think of Japan as Asia's export machine, but Japan can't hold a candle to these nations.

Japan's 1988 trade surplus, at 3 percent of GNP, was well under half of Korea's 7.4 percent and less than a third of Taiwan's 11 percent surplus.

Even though Taiwan has the larger suplus, the latest Treasury report shows that Korea is clearly guilty of worse abuses.

Korea's trade surplus is growing while Taiwan's is shrinking.

Korea's currency, the won, has appreciated much less against the dollar than Taiwan's currency since the dollar's peak in 1985.

Finally, while Taiwan has begun liberalizing its foreign exchange system and dismantling capital controls, Korea is taking no such steps.

The prognosis for the future is equally dim.

Treasury reports that assurances of further won appreciation are lacking. Korea gives no indication of moving to a market-based exchange rate system, and is totally unwilling to engage in broader discussions of financial market liberalization.

I urge Treasury to continue its efforts to end currency manipulation and I advise the Koreans to get serious about playing the game by the rules.

Unless foreign governments are willing to trade freely and fairly, it is certainly my intention to see that tough trade remedies are applied to help them see the light.

Thank you, Mr. Chairman.

The CHAIRMAN. I will yield in a moment to Senator Kerry, but I want to say to Senator Heinz and to you, Mr. Mulford, that—Senator Heinz, we both serve on the Finance Committee. We're the only two members of the Banking Committee that do—well, I guess Bill Roth now has joined us and he's a member of that committee as well, so we have three now.

CHANGE IN THE GLOBAL FINANCIAL SYSTEM

The change in the global financial and economic system has been so rapid and so multifaceted just in the last few years if not in the last few weeks, the changes each day are almost hard to keep track of. And I think that we ought to continue this discussion both in private and in public. I think it's important to have the kinds of meetings—and I mentioned before you arrived that we will have much more to do with this part of the Treasury Department's activities in the future as a committee because this is a very important part of our work here and probably not emphasized sufficiently in the past, but we're not in the past. We are in today and we will be much more involved in it in the future.

I'd like to suggest that what we ought to do—and I'd like to work with you on this—is to get this out in the public arena. It's very important that it be part of the public debate so that everybody has a chance to think about it and develop an opinion about it.

I would envision before long—currently we've got the savings and loan issue to move on through—having a hearing or a series of well constructed hearings here, where we can set in motion the kind of searching examination of where it is we are. Where is the United States in terms of these economic and financial trend lines today and where are we going in the world economy. There's a lot of carryover thinking of a decade ago or two or three decades ago that really may not be terribly relevant any more to what we find.

I think it's significant that we have had on a Friday morning with the Senate not in session eight Senators present on this sub-

ject, which would seem on the surface to be somewhat arcane, somewhat narrow, but I think it's an illustration of the fact that it goes right to the heart of the where we are and what our future is going to look like questions. It's of tremendous strategic significance. I think it's every bit as important, if not more important, than defense policy because you can't pay for defense if you don't have a strong economy, and you don't have a strong economy unless you really are functioning well in a global setting. I think the trend lines are very perverse in that respect.

I want to just say two other things and then yield to Senator Kerry. You mentioned earlier that we were making progress on the trade account. I follow that very closely. I think we've stopped making material progress in the trade account. We made some last year. I think the Super-301 process may help us just the way this focus on exchange rates has helped us to some extent with both Korea and Taiwan. But we have pretty much leveled out in terms of trade improvement in our balance of trade and that's alarming to me.

So I just want to file that dissent from what I heard or thought I heard you say, that we made improvement and seemed to be continuing to make improvement. I don't see the sustained improvement.

Mr. MULFORD. I said we were slowing down.

The CHAIRMAN. Well, I think we have more than slowed down. I think we have, in a sense, stalled out on that and I think, if anything, the trade account is likely to get worse here. That's a personal view and the data will come in and we'll see. I hope I'm wrong, but that's the clear sense I have.

The second is this. You make the point that if the foreign debt keeps growing, if our debtor nation problem keeps growing and we hit that trillion dollar debt position as a nation in 1992 or thereabouts, that that's a long-term problem. I don't think it is a long-term problem and I don't think Secretary Brady has indicated that in his view it's a long-term problem.

If you go back—and I won't take the time to read the entire quote—but again, citing this article that's just run in the Harvard Business Review magazine, and that is that his very clear conviction is that the trigger for the stock market crash—and I will read this one direct sentence from him—this is Brady talking—he said that "the real trigger is that the Japanese came in for their own reasons and sold an enormous amount of United States Government bonds and drove the 30-year Government bond up through 10 percent and when it got through 10 percent it got a lot of people thinking, 'Gee, that's four times the return we can get on equity. Here we go, inflation again.' And to me is what really started the 19th, a worry by the Japanese about the United States currency." End of quote, Nick Brady.

Now you don't have to agree with him and he may not be right, though I give some considerable weight to his view. That's something that happened in the past. I don't think our position—I don't argue that the financial market juxtaposition is precisely the same today as it was then, although overall stock averages, such as the Dow Jones, are getting back up to the same level. There are some other things that are different.

But the notion that somehow we're out of a position of jeopardy and the pileup of international debt is a long-term problem that's way out on the distant horizon, I just think is just wrong. I think it's just an incorrect reading of the situation.

FED HAS VERY LITTLE MANEUVERING ROOM

I think the Federal Reserve Board today has very little maneuvering room, partly because we've gotten ourselves in this box with a huge fiscal deficit and a huge external deficit, and I hope there's a real sense of urgency about correcting these imbalances within the Treasury Department because, if there isn't, if there's a feeling that we can sort of ride these trend lines another 6, 7, 8 years or even 3, 4 or 5 years, I think that's a serious error in judgment.

Mr. MULFORD. Mr. Chairman, I'd like to correct any misunderstanding that I have left in your mind that I or the Treasury Department do not regard the further adjustment of external imbalances as a high priority issue.

The question I was addressing an answer to earlier was the question of when having a large indebtedness might turn out to have a certain kind of an impact, and I was trying to create the impression that that's a hard judgment to make. Probably you can live with that situation for a while, but that does not mean that you can or should have a policy where you simply live with trend lines.

It is a very high priority with us to engage our major trading partners continuously in the coordination process and attempt, first of all, to represent what we're doing, which we hope as I said is going to be further reduction in our fiscal deficit, but seek from them stronger domestic demand growth in countries that are surplus countries and to make other structural changes in their economies, to increase domestic demand growth, to open their markets for trade, so that we can further move the adjustment process forward.

I agree with you that if we don't do that, if we lose that momentum for any substantial period of time and suffer a substantial reversal, financial markets will make an adverse judgment. There is no doubt about that.

So for that and other reasons, we must continue to make progress as a matter of the highest priority.

The CHAIRMAN. Well, I think that's a helpful addition and I think that's profoundly in the interest of the other nations. They may not see it that way in the first instance, but if we get into a situation where we have real turmoil in the financial market situation which could come or a serious recession or skyhigh interest rates, it will hurt us a lot but it will end up hurting everybody else as well.

Senator Kerry.

Senator KERRY. Thank you very much, Mr. Chairman. I certainly agree wholeheartedly with the comments that you've just made and would associate myself with them as forcefully as I can and would add also that I think that, as I listen to the mood here and feel the mood in the Congress, as well as in the country, I think we're dealing with something very new and very different.

And whether it's going to manifest itself in the debate over the FSX or whether it's going to manifest itself when we get into the financial services products debate here, as we ultimately will later in the year, I think it's going to be formulated in a new atmosphere of deepened frustration and impatience about the degree to which we have back-peddled and back-stepped with respect to many of these issues over the last 8 years and I think we're all going to be looking for a much more significant application of each and every power that we have created in the last couple of years, whether it's the Super-301 process or whatever, to help work this out.

I was meeting yesterday with the Taiwanese representatives and I know that they are concerned about what may be the response of the United States. And I think the specter of this incipient movement, both within Congress and outside, that is exhibiting its impatience is perhaps the first sign that we are eliciting some initial concern and response from many in these countries.

My initial question to you is whether or not the appreciation of currency in Taiwan recently, somewhere in the 50 percent range I guess, is that an accurate reflection of the appreciation, No. 1; and No. 2, is that a sufficient appreciation at this point to have had any real impact on the flow?

Mr. MULFORD. Well, the Taiwanese over the period that we've been discussing currency appreciation with them, which dates back to about September 1986, have made progress very slowly at first but—as I described before you arrived the pace of improvement has been substantially improved in that period since our first report last October. Taiwan has moved its currency as of a couple of days ago something like 12 percent. The comparable figure from the time of the Plaza, which was September 1985, is a move of 57 percent by Taiwan. So as you can see, a substantial proportion of it has been accomplished relatively recently.

Another point I would make in favor of the Taiwanese is that they introduced in early April, on April 3, a new regime in Taiwan for the way in which their currency operation is handled. It is a more market-sensitive approach which I can describe if you want to hear it in detail.

The effect is that it's more market-sensitive and since they made that change—and we have looked at that favorably but we have not made a judgment until we see how it works because it could still be manipulated, but it is more market-sensitive—but they have moved their currency a further 6 percent in the last month.

So partly we think that is the effect of the more market-sensitive system which is now reflecting to some extent the natural propensity of the currency to appreciate with Taiwans' surplus the way it is.

TAIWAN TRADE SURPLUS REDUCED WITH UNITED STATES

Meanwhile on the trade front, Taiwan's trade surplus has been reduced with the United States in 1988 approximately 26 percent. Of course, a large part of that was accounted for by gold purchases,

but still, it's a substantial adjustment. And although their surplus is still too large and we need to see it come down further, the trend continues to be favorable.

Senator KERRY. With respect to Korea, in the report it says, "Korea has not provided indications that it intends to move to a market-based system of exchange rate determination over the medium term nor is Korea willing to engage in broader discussions on financial market liberalization."

In his testimony, Secretary Brady, I gather, said that—he acknowledged the need to engage the government in a broad dialog on capital markets and particularly on banking and securities markets.

I have met with a number of U.S. financial institutions over the course of recent weeks, and they report that rather than even stabilizing or getting better, things appear to be getting significantly worse with Korea, that at least with respect to the banking systems as to branching, as to ATM networks, as to access to local currencies and so forth, and as there appears to be an increase in surplus, their demand for hard currencies being reduced, they appear to be even less willing to move into a posture of discussion.

So my question is, you know, where do you see us? I mean, how are we going to leverage that situation out of its current sense of stalemate and where do you see it going over what period of time?

Mr. MULFORD. Well, the conversations with the Koreans, which also started in September 1986, have been, frankly, quite frustrating. It has been difficult to get their attention on this subject, and they have not been particularly cooperative in improving their exchange market, as you point out, and they have not allowed their currency to appreciate significantly.

For example, it appreciated in that same period since the Plaza, September 1985, 34 percent, whereas the new Taiwan dollar was 57 percent. And to give you a sort of a benchmark, the Japanese yen moved against the dollar by about 80 percent. So as you can see, those two countries, under the adjustment taking place with the yen, were taking advantage of their situation by appreciating their currencies much more slowly and taking market share while they did it.

We have tried repeatedly to engage the Koreans. I personally have attempted to go there a number of times, and each time it has been regarded as politically too sensitive for me to actually arrive on the scene to conduct discussions.

We have sought to engage them in a broader discussion about their financial market.

Senator KERRY. Let me just interrupt you there for a minute, if I can.

The political sensitivities you are referring to are theirs rather than ours——

Mr. MULFORD. Theirs.

Senator KERRY [continuing]. Or is this a combination?

Mr. MULFORD. Theirs. The political sensitivities are that the currency issue in Korea is a highly sensitive political issue, and I am not trying to underrate it as a political issue, but at the moment, it is a very sensitive issue.

Senator KERRY. I understand that, Mr. Secretary, but is there a point—I keep seeing this, you know, serving on the Foreign Relations Committee, I see this in countless other arenas where we seem to be defining a set of politically sensitive criteria which hold us back from taking strong actions in certain respects, and even being present in some respects. All the while, losing significant ground in larger interests that may be at stake, simultaneously. We have seen this in Europe, we have seen it in a narcotics effect, we have seen it in the Middle East and certainly in other areas of the Far East. That concerns me, because the real war, so to speak, is on the economic front, and we are not totally engaged.

Mr. MULFORD. Well, I think that is where the real war is if you want to put it that way, but I do think we are engaged. We have met with the Koreans, but it has been too sensitive to go there, but we have engaged them, we have discussed the issue again and again.

Senator KERRY. What I am suggesting is, maybe we shouldn't be so sensitive. Maybe we ought to be more sensitive to our sensitivities.

Mr. MULFORD. Well, I think that is a question of approach, really. I think if you are about to visit a foreign country and they ask you not to come, that you shouldn't turn up. [Laughter.]

Senator KERRY. But isn't there an inevitability—I mean, if they are asking assistant secretaries and secretaries of the Treasury not to come to negotiate or talk or raise the visibility on issues, and we don't, and we don't press it, and we back off, then we are just playing into the time consumption, which is a classic part of the process here. Just eat up time, back it off another few months.

Mr. MULFORD. I don't agree with that. We have made an issue of it. It has caused problems in Korea. It seems to me that there are ways to do that, and we have made public announcements. I gave a very aggressive speech at one point, which I would be happy to send you, which highlighted this issue and caused major problems for the countries concerned. I don't regret that I did that, and I think it has a beneficial impact. Likewise, I think the report this committee has asked us to provide has been beneficial. We started our discussion along that line, and that has been a very useful tool. But I think arriving in a country and causing a reaction that might involve violence, for example, would be something I would shy away from in the early stages, certainly.

Senator KERRY. I suppose that is obviously a question of judgment. They asked us not to do a lot of things for a period of time with respect to the election process, the changing of the constitution, the rights of Kim Yung Son. I mean, you know, we persisted, and as a result, they had a democratic election.

So I just may differ with you as to whether we ought to press that or not.

But let me ask you another question. Let me ask you to first finish asking that portion of that one. How long do you see this current stalemate? Can you predict with any notion of certainty as to where you might say it is going at this point?

KOREANS APPRECIATED THEIR CURRENCY

Mr. MULFORD. Well, yes. As I said, last year the Koreans appreciated their currency by about 16 percent and this year so far by 2.7 percent. Their current account surplus figure has begun to show improvement. Their trading figure with the United States bilaterally only grew by 1 percent last year. Their early figures for this year showed a decline in the trade surplus with the United States. We don't have our figures yet, but clearly, something is happening now in Korea's trade figures, and we need to at least be sure what that is before we proceed with any sort of ultra tough measures.

Meanwhile, we have continued to engage them. We have indicated to them that it is absolutely necessary to continue appreciating their currency. We met with them just a couple of days ago. We also felt after that meeting that they were now willing to engage in a broad discussion of financial markets that would include the currency issue and invited us to come out and do so. So I think we are now on a more productive, possibly productive footing, and I would suggest that we follow that up aggressively and see what we can achieve now.

Senator KERRY. Do you have a sense of the measuring period?

Mr. MULFORD. Well, I think an important measuring period will be the time that we must make another report to this committee which will be next October, and I think, frankly, this technique is useful.

Senator KERRY. Yes. I see that my time is up. I would just like to ask one or two more questions.

The CHAIRMAN. Go ahead and continue if you want to.

Senator KERRY. With respect to the noncompetitive level of the dollar, are we stuck in that position as a result of the need to attract capital to support the deficit?

Mr. MULFORD. No. The dollar, I think, is quite competitive at this stage.

Senator KERRY. Do you believe that its current level then, we can continue—that you could predict an impact on the reduction of the current imbalance?

Mr. MULFORD. I think that is a very difficult judgment to make. It is clear that the momentum of adjustment has slowed. I think it is too early to tell whether or not it is actually stalled, as the chairman suggested with that word. It is an open question at this point. Clearly, we need to enhance the momentum. That I wouldn't debate for 1 minute. And that is an issue which we are addressing and that has two major parts to it.

One, we must make progress in reducing our fiscal deficit, and we must get our trading partners to make progress in increasing domestic demand and opening markets.

When we engage them on that subject, the very first question they ask us is, are you going to manage to reduce your fiscal deficit, because as far as we're concerned, that's the key element. We say we are making progress, but we think this is a two-way street and you need to do more to increase domestic demand and make structural changes in your economy.

Senator KERRY. Do you accept that?

Mr. MULFORD. I think that is an important proposition.

Senator KERRY. Do you think we are doing that sufficiently in the current budget agreement?

Mr. MULFORD. I think the present budget agreement is a very important step forward, and if it can be brought to fruition in terms of actual outcome, I think it will be very beneficial.

Senator KERRY. Are we in a position where our interest rates are looked into a higher level in order to attract borrowings from surplus savings countries, in order to finance that deficit?

Mr. MULFORD. I don't believe so; no.

Senator KERRY. If we don't take further action to reduce the deficit, do you feel that will exacerbate present political concerns among some about increasing the amounts of foreign investment in the United States?

Mr. MULFORD. I think if we fail to take credible action and follow through that there will a feeling around the world that the adjustment process is stalled or moving negatively, and there will be adverse market reaction to that.

TRADE WARS

Senator KERRY. Mr. Chairman, I appreciate it. I would just end my comment by saying that as I read more and more of what people are saying internationally and here and some predicting—I forget where it was—that it was a credible source, the last week or two, that suggested that—it might have been Lester Thurow speaking somewhere in a report on it, that the nineties were going to be the years of the trade wars, and that we were going to suddenly be caught up in a confrontational atmosphere. There are many of us here who hope that is obviously not true and don't want it to happen, but I sense a politics emerging out of this frustration and anger that may create some movements that are inimical to rational approach on some of this, and I hope that we are going to be able to super cooperative quickly and stronger than we have been in order to initiate some responses.

Mr. MULFORD. May I just make a brief comment there.

The CHAIRMAN. Please.

Mr. MULFORD. I think what you say is very important. In other words, the frustration level on trade issues is rising and it is an important element in the picture. I do think it is very important when we talk about economic policy coordination and the adjustment process among the major trading nations, that we bear in mind one important fact, and that is that the bulk of the adjustment that has to be accomplished will be accomplished chiefly by macroeconomic and structural changes of a very broad type, and that is why this area is so important to concentrate on. It is absolutely critical to open markets, to improve product access, to enforce our laws as regards particular products or sectors of business and industry. But important as that is, that in itself will not account for as much of the change as a successful exercise in coordinating and changing macro policies in the various countries, because they accomplish really substantial magnitudes of adjustment, and it is there that I think we are making progress and where we must hope to try to continue.

Senator KERRY. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Mulford, this has been a very important hearing this morning, I think, and it lays the foundation for additional work. I thought Senator Heinz' comment earlier was very relevant to something that you just said. I agree with you that working at that broad macro level, the leading nations of the world, is really the key to setting up a fair and rational and efficient economic and financial trading system. There are all kinds of reason why it doesn't work very well, and I think his reference to the fact that some of the countries today that are major international trading forces were not even present at post-war structure was hammered out and put in place.

I think this article by James Fallows in the "Atlantic Monthly" for May, which I suspect you have probably seen, if not, I want to recommend it you, called "Containing Japan," to me is one of a series of stories and assessments that are being done now, but I think one of the best, in that it lays out how there can be such profoundly different points of view in the world in different situations, and when they hit head on, you don't necessarily get a nice, orderly integration. You can have things that are so fundamentally different that if we just hold to a Western view of our notion of how economics should work and will work, we can get plowed under, if we are up against somebody who is approaching it a different way with a strategy that differentially works much more effectively for them than ours does for us, and that is, in essence, what that article lays out as to why we have a very substantial part of that problem, the United States with Japan directly.

It's very tough to get these issues focused. We could do it in Presidential campaigns. We didn't do it in the last Presidential campaign nor have we done it in any other recent campaign going all the way back to the sixties, because those campaigns' debates have been dominated by other circumstances, and those are the opportunities normally where the country has the chance to confront big, new looming issues, to try to understand them, look at what the policy choices are, try to figure out what the avenues are that are open to us.

I want to review, while Senator Kerry is still here, and I want to do it for the record and for the staff people representing other Senators and for yourself, under the standing rules of the Senate, rule 25, which lays out the jurisdiction of the standing committees. For this committee, the Senate Banking Committee, we are given the principal jurisdiction over the following—and I just want to tick them off, so that you sort of have a benchmark in your mind here as well.

As you might expect, banks, banking and financial institutions, economic stabilization and defense production, export and foreign promotion, export controls, Federal monetary policy, including Federal Reserve System, financial aid to commerce and industry—we hope we don't have to get into that too much. We have from time to time with Chrysler and New York City loan guarantees and things of that sort.

But then it finally has this paragraph.

Such committee shall also study and review on a comprehensive basis matters relating to international economic policy as it affects United States monetary affairs,

credit and financial institutions; economic growth, urban affairs and credit, and report thereon from time to time.

Now these broad divisions of assigned responsibility in the Senate are just about that clear-cut. So there is a lot of room for interpretation as to what that means. What I take it to mean and what this committee will henceforth take it to mean is that on this question of this broad macroeconomic strategy, both internally and as it relates to how we integrate into the world economy, that that is a central responsibility of ours, to try to make sense out of it, understand it, make sense out of the trend lines and to try to understand what the policy adjustments are that have to be made. Some specifically will fall within the jurisdiction of this committee in terms of legislative responsibilities that would be ours to take. Others might fall in other committees.

But in terms of the policy analysis and understanding, I think that principally falls in this committee. I take the time to say it, because I think the world has changed so much in the post-War era, just in the last decade, that we are not yet adjusted to thinking in terms of the kinds of frameworks, the new frameworks that are needed. And I thought your comment a moment ago was a very useful one in saying that this broad macroeconomic policy look that we have got to keep that as our major framework while we deal with these micro and technical areas that are a very important part of the whole, they have to be dealt with, but seen in the context of whether we are making progress in this broad picture and framework.

It is very hard to put into words. I don't suggest that I have done it as well just now as I would like to be able to, but I think theorists, analysts that I talk to today are themselves having difficulty inventing the phraseology and the way to depict this new reality that is upon us and continues to change each day, because it is so without precedent and sweeping in terms of its global character.

That is the basis upon which I want us to be able to engage constructively. And I will finish with this thought.

We worked on the savings and loan problem, I thought, very well, the administration and this committee. We worked through a lot of difficult issues in a relatively short space of time and cooperatively looking for the best answers that we could find to a very difficult problem.

I want to follow that same format in this line of inquiry and understanding, although it is different and in some respects far more diffuse and much harder to capture and get into the right focus. But it will be the intention of this committee and this chairman to work with you and others in the Treasury Department and other Cabinet agencies to try to make sense out of this overall new economic picture and try to make sure that we understand where it is we're going if we are on trend lines that are dangerous or unsustainable. We need to figure out strategies to get off those trend lines and get onto trend lines that are healthy and positive and are sustainable.

I think it is important that I put those statements out here, because that is the context in which I want to pursue the items here.

Let me ask you, can we have you come back when the October report is ready for release? I would like to, today, request that you

come back, presumably with the Secretary, and that we see where we are.

Mr. MULFORD. OK.

The CHAIRMAN. Can we expect to see you then?

Mr. MULFORD. Certainly.

The CHAIRMAN. Finally, let me say, Senator Dixon was here earlier, wanted to stay, had to go to the Armed Services Committee for a hearing on the FSX, another global issue, and asked to put a statement in the record, and we will insert his statement in the record.

[The complete prepared statement of Senator Dixon follows:]

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, at the outset, I want to congratulate you for calling this hearing. International economic policy issues in general, and exchange rate issues, in particular, often do not get the attention they deserve. In today's interdependent world, however, these vital issues cannot and must not be ignored.

Secretary Brady is here to talk about the Treasury Department's April report on international and exchange rate issues. I know the committee will benefit from discussing these matters with him.

As we consider the international factors that influence exchange rates, however, we should not lose sight of the fact that factors such as our presistent budget deficits are also extremely important. We have to partially finance our deficits with foreign capital, which contributes to our balance of payments deficit. Our balance of payments deficits put continuing downward pressure on the dollar, and put upward pressure on U.S. interests rates so that we can continue to attract foreign capital. Unless we get our domestic house in order, therefore, we can expect continuing problems with exchange rates and our balance of payments.

Thank you, Mr. Chairman.

STATEMENT OF THE AMERICAN IRON & STEEL INSTITUTE

The American Iron and Steel Institute ("AISI") strongly supports the statement by Senator John Heinz during the committee's May 5 hearing that South Korea's artificial manipulation of its currency has, in regard to steel and other products exported to the United States, the same effect as dumping in the U.S. market and that it, moreover, effectively provides a subsidy which should be countervailable under U.S. law. AISI also supports Senator Heinz's suggestion that currency manipulation and the unfair trade advantages it permits should be addressed in the ongoing Uruguay Round in the GATT. AISI believes that Korea's manipulation of its currency, which has been examined and deemed "unfair" by the U.S. Treasury Department, demonstrates beyond question that the Koreans are not, as they claim, "fair traders" when it comes to steel exports to the United States and thus entitled to exemption under any renewal of the Voluntary Restraint Arrangements.

The standard definition of dumping is price discrimination. Dumping is usually measured by comparing a company's prices of goods sold in the United States with prices of goods sold in the home market. Because the prices in the two markets originally are in different currencies, the pricing comparison is sensitive to changes in exchange rates. An undervalued home market currency is one way to minimize exposure to dumping charges, since it means that fewer dollars will equate to the same amount of home currency. Thus, instead of raising U.S. prices to avoid dumping charges, Korean companies that export to the United States can simply rely on an undervalued local currency to keep prices in the United States (in dollar terms) artificially low.

In addition, from an economic standpoint, it is clear that the deliberate undervaluation of the home currency bestows a benefit upon exporters which constitutes a

subsidy. Since the same amount of dollars translates into a greater amount of local currency than otherwise would be the case, exporters can benefit either by earning larger unit profits on export sales, or by lowering U.S. price to gain market share. Moreover, Korea's undervalued currency is the result of government actions which benefit primarily exporters. Korean companies that export find that they can maintain or lower U.S. prices, gain market share, and not suffer any loss of revenues as a result of currency manipulation. Producers that do not export, however, are adversely affected, because they are required to pay higher prices for imports as a result of the undervalued home currency. Currency manipulation thus constitutes a de facto export subsidy. The administration should therefore aggressively seek to categorize currency manipulation as an export subsidy in the ongoing Uruguay Round negotiations.

Mr. MULFORD. May I respond, Mr. Chairman, briefly, to your remarks a minute ago?

The CHAIRMAN. Yes.

Mr. MULFORD. I can't help thinking that there is a very important point here, and that is that what we call the economic policy coordination policy with the major nations, is a process which we will have to successfully engage in in order to be successful as a leading nation over the next decades. It is obviously an esoteric area. It's an economic subject, but it is a political process, and it is very important with our form of government, in my opinion, as the person chiefly involved in this process now for some years, that the executive branch and the Congress cooperate very closely, because to be credible in policy terms in the process, one has to be able to deliver, and these issues, as you point out, are increasingly important and visible to the American people, and they are part of our political process, and therefore, I welcome the chance to have these exchanges with you and believe that it will be helpful as we pursue the negotiations in this area with other countries to have had this kind of continuing liaison. I think it is very, very important

The CHAIRMAN. Very good. With that, Senator Kerry, unless you have another comment, I think we are finished today.

I want to thank you for your time and for the directness of your answers.

The committee stands in recess.

[Whereupon, at 11:30 a.m., the hearing was adjourned.]

[Response to written questions follow:]

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

November 29, 1989

Dear Mr. Chairman:

Enclosed are the responses to the questions submitted to Secretary Brady, pursuant to his testimony of May 5, 1989, on the Treasury Department's report to Congress on International Economic and Exchange Rate Policy. Also, I am providing you with revisions in the transcript of the hearing. I apologize for the delay in transmitting these to you.

Sincerely,

Bryce E. Harlow
Assistant Secretary
(Legislative Affairs)

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D.C. 20510

Enclosures

Question from Senator Donald W. Riegle, Jr., May 5, 1989

Question 1: The Treasury Depatment, in both its October and April reports to this Committee on international economic policy, states that continued economic growth remains the central objective of international economic policy coordination. Section 3003 of the Omnibus Trade Bill, however, states "the goal of the United States in international economic negotiations should be to achieve macroeconomic policies and exhange rates consistent with more appropriate and sustainable balances in trade and capital flows..." The law clearly has a different emphasis than the stated Treasury policy. Don't you think that the Treasury's goal in G-7 negotiations, while not ignoring continued world economic growth, should be on making sure such growth does not take place at our expense i.e. by placing the United States further in debt because of unfavorable trade and capital flows?

Answer:

We do not believe that there is any conflict between improved global growth and the reduction of external imbalances, particularly the U.S. deficit. Indeed, we have always indicated that external imbalances could not be reduced in an orderly manner without efforts by all members of the G-7 to promote sustained growth. In this context, we have pressed our major trading partners, particularly the principal surplus countries, to implement macroeconomic and structural policies to increase domestic demand growth and reduce their surpluses. As a result, economic growth last year was greater than expected, progress was made in reducing external imbalances, and exchange markets were generally stable. In this context, the U.S. trade deficit declined by about $27 billion and the improvement in the U.S. external position accounted for nearly one-third of the overall growth in the economy.

Questions from Senator Riegle

Q.2. You state on page 3 of your prepared testimony that:

> "Japan's trade surplus declined only modestly last year and is expected to be little changed in 1989. Clearly further progress is needed to implement structural reforms that will open that economy to foreign goods and services and direct production to the home market."

i. What actions would you recommend that our government take if the Japanese fail to implement structural reforms to open their economy to foreign goods and services?

A.i. Significant structural reforms are already underway in Japan that should help to remove barriers to imports of foreign goods and services. There has been a noticeable change in the attitudes of consumers, who are becoming increasingly intolerant of the high prices resulting from the existing system. The Government of Japan seems genuinely committed to reform in principle (in the last six months there have been several official studies outlining proposed steps for deregulation of the Japanese economy), but is sometimes short on specifics.

In recognition of the current situation in Japan, in addition to U.S. Govemnent concerns about continuing external accounts imblances, President Bush has now asked Secretary Brady, Secretary Baker and Ambassador Hills to pursue bilateral negotiations with Japan on structural impediments to balance of payments adjustment. In this way, USG policy would focus on harnessing the changes in progress in Japan to influence the quality and speed of structural reform in an efficient and timely method. The negotiations would focus on finding practical solutions to broad structural problems such as the saving pattern, distribution systems, industrial organization and land use. Solutions would be those within reach of the government, such as reform of laws, regulations and administrative guidance. The negotiations would require intensive research and follow-up until results are achieved. In addition to aiding our own objectives, it should be attractive to the Japanese as it would add foreign pressure to current domestic forces interested in increasing the rationality and flexibility of the Japanese economy.

q.ii. What would be the effect on our country if we continue to run massive trade and current account deficits with Japan?

A.ii. The important effects on the United States depend on our global trade and current account balances, not on the balance with any particular country. For example, in 1981 (our last current account surplus year), we had a $16 billion trade deficit with Japan, a $12 billion trade surplus with Western Europe and an

overall trade deficit of $28 billion. But with large investment and other services earnings, our current account recorded a $7 billion surplus. Thus we were adding to our international assets rather than reducing them, despite the bilateral trade deficit with Japan. Likewise, with a 1981 current account surplus of less than $5 billion, Japan's ability to add to its net assets abroad was limited. The significance of our global deficit is in its possible influence on our ability to promote growth and employment and control inflation. But these are related to the aggregate of domestic and foreign demand more than to exports to or imports from any particular country. Thus we have emphasized in the G-7 policy coordination process and in other fora the importance of action to reduce global external imbalances (in ways which support non-inflationary growth in the world economy).

Questions from Senator Riegle

Q.3. One consequence of the large trade deficits we have run with the Japanese in recent years, is that Japan now has massive amounts of dollars to invest in this country. What risks, if any, does this situation pose for our society? Is it a matter about which we should have concerns?

A.3. We welcome foreign investments that flow in response to market forces, whether it is from the United Kingdom, the Netherlands, Japan or any other country, and do not believe they pose any risks for the United States. The share of foreign ownership of U.S. assets is still quite small relative to U.S. GNP and our total asset base. The Administration has the ability to block or delay foreign investment where it is necessary to protect our security or international obligations.

In any case, Japanese portfolio or direct investment in the United States, whether measured in stocks or flows is not the largest single country volume of foreign investment in the United States. The largest foreign investors in the United States are the United Kingdom and the Netherlands.

Foreign investment in the United States contributes to efficiency, growth in jobs and output. It can contribute to the process of reducing the U.S. trade deficit and corresponding surpluses in other industrial countries, insofar as it helps to strengthen U.S. investment and our ability to export and produce import substitutes.

Secretary Brady Answer to Senator Garn Q1, 5/5/89

Q.1 The report projects favorable industrial country growth in 1989 with moderate inflation but it downgrades the asessment in the last report for improvement in the trade balance. The U.S. current acount deficit declined by $20 billion in 1988 to $135 billion but it is still very large and adjustment is slowing.

Is a deficit well over $100 billion sustainable over the medium-term? How serious are the prospects for a "hard landing" due to loss of confidence in the dollar and the U.S. economy?

A. It is not possible to predict what level of external deficits would be "sustainable", defined as able to be financed without exchange market pressure for further dollar depreciation. However, it seems very unlikely that persistent deficits of over $100 billion would be "sustainable" in this sense. For deficits to be "sustainable", it seems necessary to establish a clear medium-term trend toward deficits well below $100 billion.

I would not want to speculate on the factors that might cause a loss of market confidence in the dollar. Clearly the willingness of foreign investors to place their funds in dollar assets depends importantly on the U.S. pursuing economic policies which will produce sustained, non-inflationary growth, continued reduction in our trade and current account deficits, and a tax and regulatory climate attractive to both foreign and domestic investment.

Senator Garn (Q2): With the Koreans arguing against further exchange rate adjustment, how realistic is substantial market opening in Korea and Taiwan in the near-term?

A: Despite Korea's resistance to further won appreciation at this time, due primarily to its concern about the decline in the trade surplus so far this year, Korea recently agreed to undertake further trade and investment liberalization measures. Taiwan has also recently implemented and committed to further market opening actions. Further exchange rate appreciation in Korea is required, however, to help ensure that this market opening results in a sustained reduction in Korea's external surplus.

Secretary Brady (first part of three) to Senator Garn Q2, 5/5/89

Q.2. The report implies that 1989 trade performance could deteriorate if various questionable external developments do not occur: higher growth in Europe, "exchange rate developments," market opening in Korea and Taiwan, and sustained LDC growth.

While statements regarding the G-7 seem to represent agreement that a lower dollar is appropriate, the dollar has appreciated in recent months. What trade-beneficial "exchange rate developments" do you anticipate? How large a change would be needed to alter the trade picture noticeably?

A. The recent rise of the dollar, if sustained or extended, would be counterproductive to international efforts to adjust external imbalances and is a matter of concern. We are cooperating closely with our major trading partners to deal with exchange market pressures. At the same time, however, we need to avoid actions that could trigger an excessive decline of the dollar, which could also be counterproductive to adjustment efforts. In these circumstances, it would not be appropriate to suggest a specific exchange rate change. Moreover, the adjustment of external imbalances cannot be achieved by relying solely on exchange rate changes, but must be the product of the wide range of economic and structural policies in the U.S. and abroad which influence trade and capital flows.

Initiative to Strengthen the International Debt Strategy

QUESTION: How important is the success of the Brady debt proposals to the sustained LDC growth mentioned in the report? If the banks and debtors do not achieve success in managing the LDC debt burden, how severe will the impact be on the U.S. trade position?

ANSWER:

The highly indebted countries must successfully implement market-oriented macroeconomic and structural policy reforms in order to achieve sustained growth and ultimately resolve their debt servicing problems. The recent initiative reaffirms the role of the World Bank and IMF in encouraging strong debtor reforms and is designed to mobilize financial resources more effectively. The combination of debt and debt service reduction, new lending, foreign direct investment and flight capital repatriation has great potential to provide adequate financial support for individual country reform efforts and foster sustained growth. The new emphasis on debt and debt service reduction could free up debtor country resources for new investment and expand their capacity for imports.

It is important not to exaggerate the adverse impact of the developing country debt problems on the U.S. trade position. U.S. exports to the major LDC debtor countries peaked in 1981, but these levels were unsustainable because this trade was being financed with foreign borrowing beyond the capacity of these countries to service. Commodity prices were also at record highs in 1980 and 1981. While it is true that U.S. exports to heavily-indebted countries fell sharply in 1982-83, overall U.S. exports have since increased to historically high levels. Since 1985, U.S. exports to the highly-indebted countries have recovered and are at their highest levels since 1981.

The agenda for policy reform under the debt strategy not only encompasses broad structural reforms, but has also encouraged debtor governments to revamp their restrictive trade and investment regimes. Trade policy loans by the World Bank have included conditions to reduce quotas, tariffs, non-tariff barriers, and subsidy programs. All of these reforms work to the advantage of U.S. manufacturing and agricultural sectors.

The recovery of U.S. exports to the major debtor countries and substantial trade liberalization have already been achieved. We are confident that the new approach, with greater emphasis on debt and debt service reduction, will build on this past success and significantly improve the prospects for these countries to achieve sustainable growth. The initial adjustment phase by debtor countries which adversely affected U.S. exports is now behind us. We believe that the new debt initiative will further increase opportunities for U.S. exporters.

Senator Heinz Question

Q.1. While testifying, Mr. Mulford agreed that another way to view exchange rate manipulation is as an export subsidy. Should not currency manipulation, of the kind described in the report, be considered an export subsidy under United States antidumping and countervailing duty laws?

A.1. As provided in the Omnibus Trade and Competitiveness Act of 1988, the response to exchange rate manipulation is negotiations to ensure that countries alter their exchange rate policies to permit effective balance of payments adjustment. We believe this is the appropriate and most effective means of dealing with this problem and is producing considerable progress. In this connection, it should be pointed out that border measures offer only a limited remedy. They can only address the competitiveness of those imports that are injuring makers of like products in the United States; this will be a small portion of total imports. Furthermore, border measures can do nothing to address the effect of exchange rates on the competitiveness of U.S. exports. They cannot address the effect of exchange rates on investment decisions or the growing trade in services.

QUESTIONS FROM SENATE BANKING COMMITTEE

Senator Heinz (Q2): The report identified two countries as currency manipulators, Korea and Taiwan. Discussion at the hearing, however, provided little insight as to exactly how this manipulation takes place. Provide a detailed analysis of how this currency manipulation works using either an actual case, possibly with disguised identities, or an accurate hypothetical case.

A: An individual or company wishing to buy or sell foreign exchange must conduct the transaction with an authorized Korean foreign exchange bank or a branch office of a foreign bank in Korea at a rate that reflects the won-dollar rate announced by the Central Bank. In the past two years, the government has tightened up on foreign borrowing, an alternative avenue that had been available to major Korean corporations for obtaining foreign exchange either for purchasing imports or for converting into won for operating costs. The government has also taken steps to control remittances of foreign exchange from Koreans resident abroad for conversion into won, because it viewed these as motivated largely by a desire to profit from the appreciating won. Foreign investors with subsidiaries or other operations in Korea have also experienced growing difficulty in bringing in additional foreign exchange for conversion into won. Such controls on capital inflows have the effect of reducing the demand for won, thus tending to restrain won appreciation. At the same time, the government has increased the ceilings under which foreign exchange outflows for tourism, payment for other services, or investments abroad are automatically permitted. This has had the effect of stimulating long-repressed demand for foreign exchange for these purposes, thus also tending to dampen pressures for won appreciation.

In Taiwan, prior to early April, the official, quoted value of the New Taiwan (NT) dollar was set in the interbank market, which includes the foreign exchange activities of foreign banks. The daily value of the NT dollar was determined by the weighted average of interbank NT dollar-US dollar transactions on the previous business day. There was also a bank-customer market where individuals or companies were free to buy or sell foreign exchange from a bank on a "spot market" basis or "forward market" basis. The authorities were able to exercise control by limiting fluctuations in the rate to 2.25% for interbank transactions and by various margins for bank-customer transactions. Also, to limit speculation on the appreciation of the NT dollar, capital inflows were limited to $50,000 yearly for each individual or entity. More importantly, the Central Bank intervened on a

large-scale in the foreign exchange markets, most often to limit appreciation of the NT dollar.

Under the new system initiated in early April, all NT dollar-US dollar transactions by individuals and businesses above $30,000 are at freely determined rates. The rate for smaller transactions is determined by a committee of banks based on the free market rates. However, the continuation of the Central Bank's ability to intervene in the market and the capital inflow restrictions still allow for some control of the exchange rate.

Questions from Heinz

Q.3. The cost of capital is very low in Japan. American companies doing business in Japan say, however, they are not able to take advantage of the availability and low cost of capital because it is not accessible to them. What is the situation for American companies wishing to raise capital in Japan? Is lack of access a form of currency manipulation or capital control as discussed in the case of Korea and Taiwan?

A.3. It is our impression that there is no pervasive and consistent discrimination in terms of access of U.S. corporations to yen funds in Japan. Therefore, we do not believe that there exists a form of currency manipulation or capital control as discussed in the case of Korea and Taiwan. Below we differentiate between the situation for financial and non-financial U.S. firms wishing to raise capital in Japan.

In general, we do not believe that foreign and Japanese non-financial firms with comparable credit ratings pay different amounts for yen funds. In fact, regarding bank loans, we hear that some Japanese banks have been actively courting new customers, including foreign firms. However, the long-term relationship between Japanese banks and their corporate customers could occasionally result in more favorable terms to the Japanese company, but we do not believe that practice is widespread. The recent introduction of a market based short-term prime rate (previously the prime rate had been linked to the official discount rate) should ensure equal credit costs. The short-term prime lending rate is now about 4.5 percent. In addition to domestic sources of funds, both foreign and Japanese non-financial firms are able to raise funds easily in the euroyen market. Convertible bonds and bonds with warrants are frequently used by Japanese borrowers in the euromarkets. Given the nature of these instruments, these are typically issued with a relatively low coupon.

Regarding financial firms, interest rate deregulation is gradually being pursued in Japan which will have the final effect of removing the availability of a substantial pool of low cost funds for domestic banks with a wide deposit base. Recent reforms in the Japanese interbank market are also evening out the discrepancy between costs to domestic and foreign banks borrowing in the short term money market. Short-term money market rates are currently around 4.5 percent. The Bank of Japan does maintain a very short-term lending facility to a select group of ten domestic banks at the same rate as the official discount rate (2.5 percent). Lending has been used as a supplemental way of adding or absorbing reserves and the total amount is small in relation to total bank liabilities.

Questions From Heinz

Q.4. In his testimony, Mr. Mulford spoke of recent negotiation successes in discussions aimed at internationalizing the yen. By way of example, he referred to the increasing volume of new issues, denominated in yen, in the Euromarket. Provide current figures for the volume of new issues and the volume of currency transactions in Euroyen, drawing a distinction between the two. Compare those figures to similar figures for the Eurodollar.

A.4. While there has been significant improvement in the internationalization of the yen, there is still room for further progress before global use of the yen will be commensurate with Japan's advanced stage of economic and financial development. Following the recommendations of the 1984 Yen/Dollar Committee to open a euroyen bond market in order to increase the internationalization of the yen, the Euroyen bond market grew from $1 billion in its first year to $7 billion in 1985 to $23 billion in new issue activity in 1987. Meanwhile, the Eurodollar new issue activity dropped from $93 billion in 1985 to $56 billion in 1987. The international yen sector (euroyen and foreign issues in Japan) in 1987 at $25 billion was second only to the international dollar sector at $62 billion, ahead of the international Swiss franc, sterling and DM bond markets. In 1988, new issue activity in the Euroyen market eased to about $17 billion while Eurodollar new issuance increased slightly to $69 billion. In the first four months of 1989, new issue activity in the international yen sector (including the Euroyen bond market) was approximately $6 billion, compared to $45 billion in the international U.S. dollar sector, just over $6 billion in the DM market and approximately $7 billion in the sterling market.

Other data on global use of the yen, such as the volume of yen currency transactions or yen denominated trade, is difficult to find. Data from the International Monetary Fund on the currency composition of official reserve assets shows that the use of yen as a share of world official holdings of foreign exchange rose from 3.6 percent in 1979 to 7.0 percent in 1987. Over the same period the dollar's share in total official holdings of foreign exchange dropped from 73.2 percent in 1979 to 67.1 percent in 1987.

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